Supreme Court, U.S.
FILED
02 1745 MAY 27 2003
OFFICE OF THE CLERK

No.

IN THE

Supreme Court of the United States

THE TRAVELERS INSURANCE COMPANY,
Petitioner

v.

UNITED STATES OF AMERICA,
Respondent

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

PETITION FOR WRIT OF CERTIORARI

PETER H. WINSLOW
Counsel of Record
BIRUTA P. KELLY
GREGORY K. OYLER
Attorneys
Scribner, Hall & Thompson, LLP
1875 Eye Street, N.W.
Suite 1050
Washington, D.C. 20006-5409
(202) 331-8585

Counsel for Petitioner

102 pp

QUESTIONS PRESENTED

1. Whether the Federal Circuit erred in requiring the policyholders' share of investment income under 26 U.S.C. § 809(a) to be treated as a permanent exclusion from gross income for purposes of computing a foreign tax credit under 26 U.S.C. §§ 901 and 904, where Treasury Department regulations provide that the same § 809(a) policyholders' share must be treated as part of the deduction for reserves, and not as an exclusion, for purposes of determining taxable income from U.S. and foreign risks?

2. In light of inconsistencies in application by the federal circuit courts of appeal of this Court's decisions on judicial deference, whether the Treasury Department regulations issued pursuant to 26 U.S.C. § 7805(a) are entitled to deference in computing Travelers' foreign-source income for purposes of the foreign tax credit where the regulations: (1) were promulgated after notice and comment under an express grant of congressional authority; (2) interpret the same statute and issue in dispute in this case; and (3) promote the same congressional objectives of clear reflection of U.S. and foreign-source insurance income; even though the regulations relate to subpart F income and not the foreign tax credit?

PARTIES TO PROCEEDING AND CORPORATE DISCLOSURE STATEMENT

The party to the proceeding whose judgment is sought to be reviewed is The Travelers Insurance Company. Its parent corporations and the publicly held companies that own 10 percent or more of its stock are Citigroup Inc.; Associated Madison Companies, Inc.; and Citigroup Insurance Holding Corp.

TABLE OF CONTENTS

PETITION

QUESTIONS PRESENTED i

PARTIES TO PROCEEDING AND CORPORATE DISCLOSURE STATEMENT .. ii

TABLE OF CONTENTS iii

TABLE OF AUTHORITIES v

PETITION FOR WRIT OF CERTIORARI 1

OPINIONS BELOW 1

JURISDICTION 1

STATUTORY AND REGULATORY PROVISIONS INVOLVED 2

STATEMENT OF THE CASE 8

REASONS FOR GRANTING THE PETITION 20

A. Important Questions Upon Which Guidance Is Needed Are Raised by the Court of Appeals' Failure to Defer to the Treasury Regulations' Interpretation of the Statute 20

B. The Court of Appeals' Judgment Is Wrong 27

CONCLUSION 30

APPENDIX

OPINIONS ENTERED BY THE COURTS BELOW

Travelers Ins. Co. v. United States, 28 Fed. Cl. 602 (1993), *rev'd*, 303 F.3d 1373 (2002) 1a

The Travelers Ins. Co. v. United States, 303 F.3d 1373 (2002), *rev'g* 28 Fed. Cl. 602 (1993) 26a

ORDER ON REHEARING

The Travelers Ins. Co. v. United States, 319 F. 3d 1380 (2003) (Order *granting in part and denying in part reh'g of* 303 F.3d 1373 (2002)) 57a

JUDGMENT TO BE REVIEWED

Judgment issued in *The Travelers Ins. Co. v. United States*, Fed. Cir. No. 01-5137, reversing *Travelers Ins. Co. v. United States*, 28 Fed. Cl. 602 (1993) (dated Sept. 16, 2002; issued as a mandate Apr. 17, 2003) 61a

TABLE OF AUTHORITIES

FEDERAL CASES

American Chicle Co. v. United States,
316 U.S. 450 (1942) 28

Associated Telephone and Telegraph Co. v. United States, 306 F.2d 824 (2d Cir. 1962) 27

Bank of America v. United States,
680 F.2d 142 (Ct. Cl. 1982) 11, 28

Bankers Life and Casualty Co. v. United States,
142 F.3d 973 (7th Cir. 1998) 24

Black & Decker Corp. v. Commissioner,
986 F.2d 60 (4th Cir. 1993) 10

Burnet v. Chicago Portrait Co.,
285 U.S. 1 (1932) 9, 28

Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984) ..... passim

Cottage Savings Ass'n v. Commissioner,
499 U.S. 554 (1991) 24

E.I. du Pont de Nemours & Co. v. Commissioner,
41 F.3d 130 (3d Cir. 1994) 24

Nalle v. Commissioner,
997 F.2d 1134 (5th Cir. 1993) 24

National Muffler Dealers Ass'n v. United States,
440 U.S. 472 (1979) 20, 24, 25
26

Occidental Life Ins. Co. v. United States,
250 F. Supp. 130 (S.D. Cal. 1965),
aff'd in part (rev'd in part on other issue),
385 F.2d 1 (9th Cir. 1967) 12

Pacific First Federal Savings Bank v.
Commissioner, 961 F.2d 800 (9th Cir. 1992) 24

Peoples Federal Savings and Loan Ass'n v.
Commissioner, 948 F.2d 289 (6th Cir. 1991) 24

Skidmore v. Swift & Co.,
323 U.S. 134 (1944) 22, 24, 25
26

United States v. Atlas Life Ins. Co.,
381 U.S. 233 (1965) 13

United States v. Cleveland Indians Baseball Co.,
532 U.S. 200 (2001) 24

United States v. Mead Corp.,
533 U.S. 218 (2001) ..... passim

FEDERAL STATUTES

Life Insurance Company Tax Act of 1959,
Pub. L. No. 86-69, 73 Stat. 112 12

Revenue Act of 1962,
Pub. L. No. 87-834, 76 Stat. 960 16

26 U.S.C. § 802 ..... 2, 4, 12
14

26 U.S.C. § 804 ..... 2, 3, 14

26 U.S.C. § 809 ..... passim

26 U.S.C. § 810 ..... passim

26 U.S.C. § 841 ..... 4, 12, 27

26 U.S.C. §§ 861-864 ..... 5, 10, 27

26 U.S.C. § 901 ..... passim

26 U.S.C. § 904 ..... passim

26 U.S.C. § 907 ..... 6, 10, 27

26 U.S.C. § 953 ..... passim

26 U.S.C. § 954 ..... 7, 17

26 U.S.C. § 7805 ..... passim

28 U.S.C. § 1254(1) 1

TREASURY REGULATIONS ON INCOME TAX

26 CFR § 1.861-8 ..... passim

26 CFR § 1.953-1 7

26 CFR § 1.953-4 ..... 7, 16, 17

26 CFR § 1.953-6 ..... 7, 17

Treasury Decision 6781,
29 Fed. Reg. 18,201 (1964) 25

Notice of Proposed Rulemaking,
29 Fed. Reg. 10,603 (1964) 25

MISCELLANEOUS

H.R. Rep. No. 855,
76th Cong., 1st Sess. (1939) 9

H.R. Rep. No. 34,
86th Cong., 1st Sess. (1959) 12, 15, 29

S. Rep. No. 291,
86th Cong., 1st Sess. (1959) 12, 13, 15
28

Rev. Rul. 68-622,
1968-2 C.B. 298 25

John F. Coverdale, *Court Review of Tax Regulations and Revenue Rulings in the Chevron Era*, 64 Geo. Wash. L. Rev. 35 (1995) 26

John F. Coverdale, *Chevron's Reduced Domain: Judicial Review of Treasury Regulations and Revenue Rulings After Mead*, 55 Admin. L. Rev. 39 (2003) 24

Elisabeth A. Owens, *The Foreign Tax Credit: A Study of the Credit for Foreign Taxes Under United States Income Tax Law* (1961) 9, 28

PETITION FOR WRIT OF CERTIORARI

The Travelers Insurance Company (Travelers) respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Federal Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App. 1a-25a) is reported at 303 F.3d 1373. The opinion of the trial court (App. 26a-56a) is reported at 28 Fed. Cl. 602.

JURISDICTION

The judgment of the court of appeals was entered on September 16, 2002 (App. 61a). Petitioner timely filed a petition for rehearing, which was granted in part and denied in part by order dated February 24, 2003 (App. 57a-60a). The judgment was issued as a mandate on April 17, 2003 (App. 61a). The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

1. 26 U.S.C. § 802(a)[1] provides in relevant part:

> A tax is hereby imposed . . . on the life insurance company taxable income of every life insurance company. . . . as though the life insurance company taxable income were the taxable income referred to in section 11.

2. 26 U.S.C. § 802(b) provides in relevant part:

> For purposes of this part, the term "life insurance company taxable income" means the sum of –
>
> (1) the taxable investment income (as defined in section 804) or, if smaller, the gain from operations (as defined in section 809),
>
> (2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus
>
> (3) the amount subtracted from the policyholders' surplus account for the taxable year, as determined under section 815.

---

[1] During 1975-1980, the tax years in issue, some of the statutes and regulations referred to here were amended. However, the statutory and regulatory language quoted here remained substantially the same throughout this period.

3. 26 U.S.C. § 804(a) provides in relevant part:

> The policyholders' share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company shall not be included in taxable investment income.

4. 26 U.S.C. § 809(a)(1) provides in relevant part:

> The share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company set aside for policyholders shall not be included in gain or loss from operations.

5. 26 U.S.C. § 809(d) provides in relevant part:

> [T]here shall be allowed the following deductions:
>
> (1) . . .
>
> (2) Increases in certain reserves. – The net increase in reserves which is required by section 810 to be taken into account for purposes of this paragraph.

6. 26 U.S.C. § 810(b) provides in relevant part:

> If the sum of the items described in subsection (c) [(reserves and certain other amounts set aside)] as of the close of the taxable year (*reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1)*) exceeds the sum of such items as of the beginning of the taxable year, the excess shall be taken into account as a net increase referred to in section 809(d)(2). (Emphasis added.)

7. 26 U.S.C. § 841 provides in relevant part:

> The taxes imposed by foreign countries or possessions of the United States shall be allowed as a credit against the tax of a domestic insurance company subject to the tax imposed by section 802, 821, or 831, to the extent provided in the case of a domestic corporation in section 901 (relating to foreign tax credit). For purposes of the preceding sentence . . ., the term "taxable income" as used in section 904 means –
>
> (1) in the case of the tax imposed by section 802, the life insurance company taxable income (as defined in section 802(b))
>
> . . . .

8. 26 U.S.C. § 863(a) provides in relevant part:

> Items of gross income, expenses, losses, and deductions, other than those specified in sections 861(a) and 862(a), shall be allocated or apportioned to sources within or without the United States, under regulations prescribed by the Secretary.

9. 26 U.S.C. § 901(a) provides in relevant part:

> If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the applicable limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960.

10. 26 U.S.C. § 901(b)(1) provides in relevant part:

> In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country . . . .

11. 26 U.S.C. § 904(a) provides in relevant part:

> The total amount of the credit taken under section 901(a) shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but

not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year.

12. 26 U.S.C. § 907(b) provides in relevant part:

> The provisions of section 904 shall be applied separately with respect to . . . foreign oil related income . . . .

13. 26 U.S.C. § 7805(a) provides in relevant part:

> [T]he Secretary or his delegate shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

14. 26 CFR § 1.861-8(b)(1) provides in relevant part:

> Allocation is accomplished by determining, with respect to each deduction, the class of gross income to which the deduction is definitely related and then allocating the deduction to such class of gross income . . . .

15. 26 CFR § 1.861-8(b)(2) provides in relevant part:

> A deduction shall be considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived.

16. 26 CFR § 1.953-4(a)(1) provides in relevant part:

> For a controlled foreign corporation which is engaged in the business of reinsuring or issuing insurance or annuity contracts and which, if it were a domestic corporation engaged only in such business, would be taxable as a life insurance company to which part I (sections 801 through 820) of subchapter L of the Code applies, the term "taxable income" means for purposes of paragraph (a) of § 1.953-1 the gain from operations, as defined in section 809(b) and as modified by this section, derived from, and attributable to, the insurance of United States risks.

17. 26 CFR § 1.953-6(b) provides in relevant part:

> Thus, in applying § 1.953-4 to the income of a controlled foreign corporation . . . , there shall be allowed, in determining the taxable income derived from the insurance of United States risks under § 1.953-4, a deduction under section 809(a)(1) for the share of each and every item of investment yield set aside for policyholders; it is not material that in determining foreign base company income such deduction would not be allowed under section 954(b)(5).

STATEMENT OF THE CASE

This case concerns two issues relating to the proper scope of judicial deference to Treasury regulations (26 CFR) that interpret the Internal Revenue Code (26 U.S.C.), and arises in the context of computing Travelers' foreign tax credit. The first question is whether the court of appeals was required to defer to interpretative Treasury regulations (26 CFR § 1.953) that set forth the agency's interpretation of § 809(a)[2] – the same statute involved in this case – in a different context. A second related question is what degree of judicial deference is necessary.

The court of appeals did not address the regulations, but instead relied on its own interpretation of the statute. The effect of the court of appeal's judgment is to reduce inappropriately the amount of foreign-source income on which Travelers' foreign tax credit is based, thereby subjecting Travelers' foreign income to double taxation. The court of appeals erred because judicial deference to the Treasury regulations is required. The regulations represent the agency's exercise of notice-and-comment rulemaking authority under § 7805(a). Even though, by its terms, the regulations apply to controlled foreign corporations, they interpret the same statute that is in dispute in this case, for the same general purpose. The court of appeal's holding permits the Treasury Department to adopt conflicting positions as to the proper interpretation of the statute, depending on whether revenue is increased or not. Further review is warranted in this case.

---

[2] Unless otherwise stated, all references to a "§" are to a section of 26 U.S.C., as in effect during the years in issue.

1. Travelers is an insurance company engaged in the business of writing life insurance and accident and health insurance and is taxable in 1975 through 1980 under subchapter L of the Internal Revenue Code (§§ 801-820). In the 1970s and 1980s Travelers invested in a joint venture engaged in oil exploration and drilling off the coast of Sumatra. On its federal income tax returns for 1975 through 1980, Travelers reported its share of the joint venture's gross income and expenses. Travelers also claimed a foreign tax credit for its share of the income taxes paid to Indonesia. Absent the foreign tax credit, Travelers' Indonesian income would be subject to double taxation – once by Indonesia and again by the United States.

The foreign tax credit was enacted by Congress in 1918; "the primary design of the provision was to mitigate the evil of double taxation." *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7 (1932). The amount of the foreign tax credit is subject to a limitation, which is intended to restrict the allowable credit to the amount of the U.S. tax otherwise payable on the foreign net income. H.R. Rep. No. 855, 76th Cong., 1st Sess. 5 (1939); Elisabeth A. Owens, *The Foreign Tax Credit: A Study of the Credit for Foreign Taxes Under United States Income Tax Law 5-7* (1961). Thus, the limitation of § 904(a) provides that the total foreign tax credit shall not exceed that proportion of the U.S. tax imposed (before the credit) which the taxpayer's foreign-source taxable income for the year bears to the taxpayer's entire taxable

income (from U.S. and foreign sources). In mathematical terms, § 904(a) expresses the foreign tax credit limit as follows:

$$\text{limit} = \text{total pre-credit U.S. tax} \times \frac{\text{foreign-source taxable income}^3}{\text{total worldwide taxable income}}$$

The numerator of the above fraction – foreign-source taxable income – is the key factor in the limit on the foreign tax credit. Under the equation, a decrease in foreign-source income decreases the foreign tax credit limit.

2. The numerator of the foreign tax credit limitation is computed by application of the statutory and regulatory sourcing rules under §§ 861-864 and 904. Under § 863(a), Congress gave the Secretary of the Treasury a specific grant of regulatory authority to prescribe regulations specifying the methods for allocating and apportioning income, losses, deductions and expenses to foreign sources. "These regulations emphasize the factual relationship between the deduction and a given class of gross income, allowing deductions only against the class of gross income to which the deduction is definitely related. 26 C.F.R. § 1.861-8(b)(1)." *Black & Decker Corp. v. Commissioner*, 986 F.2d 60, 63 (4th Cir. 1993); 26 CFR § 1.861-8(b)(2) ("A deduction shall be considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to, an activity or in connection with

---

[3] In this context the foreign income consists of "foreign oil related income," or FORI, to which § 907 applies. This further complication has no impact in this case and will not be addressed further in this petition.

property from which such class of gross income is derived"). If the statute and regulations do not specify a particular rule for sourcing or allocating an item, the item is sourced or allocated according to its substance, using analogous sourcing rules. *Bank of America v. United States*, 680 F.2d 142, 147 (Ct. Cl. 1982).

A simple example illustrates the operation of the sourcing rules. Suppose a company has U.S.-source gross income of $100, foreign-source gross income of $50, and expenses of $100, leaving worldwide taxable income of $50 ($150 income-$100 expenses). This worldwide taxable income ($50) is the denominator of the limitation fraction. The numerator of the limitation fraction is computed under the principles of 26 CFR § 1.861-8 by allocating and apportioning the $100 of expenses to foreign-source income and U.S.-source income, on the basis of the factual relationship between the expenses and the income. If all the expenses were allocable to the U.S.-source income, the U.S.-source taxable income would be zero and the foreign-source taxable income would be $50, which would become the numerator of the limitation fraction. Under these facts, the denominator, total worldwide taxable income of $50, therefore, would consist exclusively of the $50 of foreign-source income. On the other hand, if after applying 26 CFR § 1.861-8, the expenses were allocable equally to U.S.-source income and foreign-source income, the U.S.-source taxable income would be $50 and the foreign-source taxable income would be zero. In this latter situation, the denominator, total worldwide taxable income, would consist entirely of U.S.-source income. In the first instance, the foreign tax credit limitation fraction would be 100% (permitting a credit against 100% of the U.S. tax); in the second instance, the limitation and the credit would be zero.

3. Life insurance companies, like Travelers, were taxed in 1975-1980 on "life insurance company taxable income" under § 802.[4] The foreign tax credit principles described above apply to "life insurance company taxable income" under § 841. *Occidental Life Ins. Co. v. United States*, 250 F. Supp. 130, 131 (S.D. Cal. 1965), *aff'd in part (rev'd in part on other issue)*, 383 F.2d 1 (9th Cir. 1967).

During the years in issue, under the Life Insurance Company Tax Act of 1959, Pub. L. No. 86-69, 73 Stat. 112 (the "1959 Act"), life insurance companies were taxed on their total income from all sources, including underwriting income and investment income.[5] H.R. Rep. No. 34, 86th Cong., 1st Sess. 12 (1959); S. Rep. No. 291, 86th Cong., 1st Sess. 20 (1959). In enacting the 1959 Act, Congress determined that it would be inappropriate to permit life insurance companies to exclude the entire amount of tax-exempt interest (such as that received on a tax-exempt municipal bond) from income and, at the same time, claim a full deduction for the policyholder claims funded by tax-exempt interest. While Congress could have adopted a simple statutory scheme to accomplish its purpose merely by requiring tax-exempt interest to be included in income to the extent such interest was set aside in reserves to fund future

---

[4] Under § 802(b), "life insurance company taxable income," is comprised of a number of component "phases" in various alternative portions and combinations, which include "taxable investment income," "gain from operations," and the "amount subtracted from the policyholders' surplus account."

[5] Even though the rules of subchapter L have since been amended and simplified, the issue of the proper allocation of the required interest portion of reserves for purposes of the foreign tax credit has continuing significance under § 818(f) of current law.

claims, it did not do so because such an approach raised constitutional questions relating to the taxation of state obligations. To avoid this problem, Congress enacted a circuitous approach to reach the desired result, by effectively disallowing the portion of the reserve deduction to the extent the reserves were funded by tax-exempt interest. *United States v. Atlas Life Ins. Co.*, 381 U.S. 233, 247 (1965); S. Rep. No. 291 at 18. Congress achieved this effect by "prorating" all investment income (not just tax-exempt interest), between the portion necessary to support reserves for policyholders (the policyholders' share) and the remaining portion (the company's share). While Congress "excluded" the policyholders' share of each item of investment income from the computation of gain from operations under § 809(a) (S. Rep. No. 291 at 17), at the very same time it reversed this exclusion by way of a dollar-for-dollar reduction in the year-end reserves taken into account in determining the reserve deduction under § 810. *Id.* at 22. The effect of this treatment for a company subject to tax on gain from operations was the same as if there were no "exclusion" and the regular reserve deduction applied – in substance a full tax on the policyholders' share of all investment income.

4. The issue in this case concerns the policyholders' share of the Indonesian investment income

under § 809(a)[6] and whether it should be treated as an exclusion from foreign-source income, or as a deduction in computing Travelers' foreign tax credit limitation for the Indonesian taxes. In most situations it would not matter for tax purposes whether an item is an exclusion or a deduction, because the effect of both approaches is to reduce taxable income. However, in this situation, an exclusion would reduce the numerator of the limitation fraction (foreign-source taxable income), while a deduction allocated and apportioned according to its factual relationship to U.S.-source income under 26 CFR § 1.861-8 would not reduce the foreign tax credit limitation.

5. On Petitioner's Motion for Partial Summary Judgment and Respondent's Cross Motion for Partial Summary Judgment, the Court of Federal Claims (lower court) held that, in computing Travelers' foreign-source income for purposes of the foreign tax credit, the policyholders' share of investment income under § 809(a) is, in substance, a portion of Travelers' deduction for insurance reserves and, as such, is properly allocable under 26 CFR § 1.861-8 to U.S.-source insurance income. The lower court considered all the life insurance company taxable income computations of subchapter L, and concluded that the "exclusion" is not a real exclusion because there is an

---

[6] There are two policyholders' share amounts, one relating to taxable investment income (§ 804(a)), and the other relating to gain from operations (§ 809(a)). In concept they are the same (but computed differently). For the years in dispute, Travelers' tax base under § 802(b) was either gain from operations or gain from operations less 50% of the excess of gain from operations over taxable investment income. For this reason, the policyholders' share under § 809(a) for gain from operations is most important to this case and is the policyholders' share discussed in this petition.

offsetting dollar-for-dollar increase in taxable income by an adjustment to Travelers' year-end reserves. 28 Fed. Cl. at 613 ("Under Section 810, the amount of net increase or decrease in reserves, must first be reduced by the amount of investment yield not included in the gain or loss from operations for the taxable year by reason of Section 809(a)(1). Treas. Reg. § 1.810-2(c)(1)."). As recognized by the lower court, the substance of this approach of excluding the policyholders' share of investment yield and the corresponding reduction in the year-end reserves is to disallow the reserve deduction, but only to the extent of the prorated portion of required interest allocable to tax-exempt interest. H.R. Rep. No. 34 at 14; S. Rep. No. 291 at 22. All other items of investment income increase a life insurance company's taxable income. Thus, Travelers' taxable income was increased by the full amount of its income from the Indonesian joint venture.

The lower court cited as support for its holding Treasury Department regulations that treat the policyholders' share in the same manner for purposes of determining the foreign-source income of a controlled foreign corporation (under subpart F of the Internal Revenue Code, § 951 *et seq.*). The lower court's decision to follow the Treasury Department's interpretation of the statutory provisions governing the policyholders' share, as reflected in the subpart F regulations, furthers the purpose of the foreign tax credit provisions to alleviate double taxation of the same foreign-source income. The lower court relied on Treasury Department regulations as follows:

> This conclusion is supported by the analogous Section 953 regulations governing income of controlled foreign corporations. Under Section 953, certain shareholders of foreign controlled corporations are required to include

> in income the amounts of their "Subpart F" income. Subpart F income includes insurance income "derived from the insurance of United States risks." Treas. Reg. § 1.953-4(h) Example (d) determines the life insurance company share of investment yield attributable to foreign risks by subtracting the required interest attributable to the reserves on foreign risks from the total investment income allocable to those risks. Thus, the policyholders' share of investment risks is equated with required interest and is an expense allocable to the source of the insurance risks to which it relates and not to all items of investment yield.

28 Fed. Cl. at 614 n.23.

6. As recognized by the lower court, the Treasury Department's interpretation of the policyholders' share in the context of foreign-source income is contained in the § 953 regulations.[7] The § 953 regulations represent the agency's conclusion that the policyholders' share should be treated as a deduction for sourcing and allocation purposes, and *not* as an exclusion. Specifically, the regulations provides:

> Thus, in applying § 1.953-4 to the income of a controlled foreign corporation . .

---

[7] The Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960, added the controlled foreign corporation provisions (subpart F) to the Internal Revenue Code. Subpart F income of a controlled foreign corporation is included in the taxable income of its U.S. shareholders. Under § 953, subpart F income includes income from the insurance of U.S. risks.

> . , there shall be allowed, in determining the taxable income derived from the insurance of United States risks under § 1.953-4, *a deduction under section 809(a)(1)* for the share of each and every item of investment yield set aside for policyholders; it is not material that in determining foreign base company income *such deduction would not be allowed* under section 954(b)(5).[8]

26 CFR § 1.953-6(b) (emphasis added). An example in the regulations demonstrates that the policyholders' share is not treated as an exclusion. 26 CFR § 1.953- 4(h), Example (d).

Thus, to measure properly U.S. and foreign-source income, the Treasury Department's regulations interpret § 809(a) as requiring the policyholders' share to be treated as a deduction. The significance of this treatment is to determine a proper apportionment of income and expenses between the insurance of U.S. risks and foreign risks. Applying such rules results in a deduction for a portion of the policyholders' share relating to U.S. risks and no deduction for the policyholders' share relating to foreign risks. The investment income relating to foreign risks is taxable as subpart F income under § 954, unreduced by any policyholders' share. If the policyholders' share were in fact an exclusion, as determined by the court of appeals, a foreign

---

[8] 26 CFR 1.861-8(f)(1)(vi) provides, in part, as follows:

> The rules provided in this section also apply in determining–
>
> . . .
>
> (K) The amount of income from the insurance of U.S. risks under section 953(b)(5).

life insurance company that is a controlled foreign corporation would include in subpart F income its investment income reduced by the policyholders' share exclusion. These regulations appropriately interpret the subchapter L rules so that the taxable income of an insurance company controlled foreign corporation is not improperly understated by the amount of the policyholders' share. Because the policyholders' share, in substance, is the investment element of the reserve deduction – "required interest" – (and not a permanent exclusion from taxable income), the § 953 regulations properly apportion to U.S. risks and foreign risks the policyholders' share as a deduction under rules similar to 26 CFR § 1.861-8. Similarly, unless the policyholders' share is allocated and apportioned consistent with the regulations, foreign-source taxable income in the numerator of the foreign tax credit limitation fraction would be improperly understated, resulting in double taxation.

7. The court of appeals reversed, relying exclusively on the "exclusion" language in § 809(a). While acknowledging that § 810 resulted in an offsetting increase in taxable income, the court found the "exclusion" label controlling, without taking into account the substance of the entire statutory scheme, the purpose of the policyholders' share rules in the context of the foreign tax credit, or the inappropriate double tax resulting from its interpretation. Equally important, the court of appeals gave no deference, and did not even consider, the Treasury Department's regulations that interpret the statute in a different manner. This Court's decisions hold that reasonable agency interpretations are entitled to appropriate deference. Thus, the court of appeals was wrong to ignore the agency's interpretation of the governing statutory provisions in the regulations.

In its opinion the court of appeals stated that no refund is due based on its conclusion that the policyholders' share is an exclusion. However, Travelers reserved its right to make several alternative arguments that would arise only if the court determined that the policyholders' share was an exclusion. These alternative arguments were not addressed by the lower court or on appeal. These alternative arguments include: (1) the increase to taxable income for the adjustment to reserves attributable to the policyholders' share increase in foreign-source income; and (2) the proper computation of the exclusion for the policyholders' share. The court of appeals' holding on the deduction versus exclusion issue does not dispose of these issues. Travelers filed a petition for rehearing, which was granted in part by the court's Order (App. 57a-60a) that the case be remanded "for the limited purpose of determining whether the IRS made a computational error with respect to the 1975 and 1978 taxable years." (App. 59a (footnote omitted).) With no explanation or discussion, the court of appeals rejected Travelers' contention that a remand is needed to address other issues concerning the foreign tax credit that have not yet been briefed or decided by any court. The court of appeals' apparent decision to restrict Travelers' day in court on these issues that have not been briefed is a manifest injustice.

REASONS FOR GRANTING THE PETITION

A. Important Questions Upon Which Guidance Is Needed Are Raised by the Court of Appeals' Failure to Defer to the Treasury Regulations' Interpretation of the Statute

The issue herein concerns how the § 809(a) policyholders' share is treated in determining foreign taxable income in the foreign tax credit limitation fraction. The court of appeals determined that the statutory language of § 809(a) that labels the policyholders' share as an "exclusion" from gain from operations under subchapter L is dispositive of the issue, even though § 810 reverses the "exclusion" so that the policyholders' share in reality is subject to U.S. tax. The court of appeals' conclusion is contrary to the regulations that determine that the § 809(a) policyholders' share is properly treated as a deduction in determining taxable income from U.S. risks. The issue of deference (or lack thereof) that the court of appeals gave these regulations raises important questions on which guidance is needed. The circuit courts currently are not in agreement on the degree of deference to be given Treasury regulations promulgated under § 7805(a). Moreover, this Court's holdings do not address specifically the degree of deference to be accorded the agency's interpretation of a statute that appears in regulations that do not have general applicability.

1. This Court's guidance on judicial deference to Treasury regulations has led to some uncertainty for the courts, government litigators and taxpayers. In a significant decision in 1979, this Court gave guidance specifically related to Treasury regulations. *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472 (1979). In that case, the

association was denied an exemption from tax as a business league, because it did not satisfy a requirement of the relevant regulations. The Court noted that Congress did not define "business league," but that it intended under § 7805(a) that Treasury regulations provide the needed rules to enforce the Internal Revenue Code. The Court held that the regulation merited "serious deference" considering the following:

> In determining whether a particular regulation carries out the congressional mandate in a proper manner, we look to see whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose. A regulation may have particular force if it is a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent. If the regulation dates from a later period, the manner in which it evolved merits inquiry. Other relevant considerations are the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner's interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent re-enactments of the statute.

440 U.S. at 477.

2. In *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), this Court addressed the scope of deference, outside the federal tax context. In *Chevron*, the Environmental Protection Agency (EPA) adopted a regulation interpreting the statutory term "stationary source." The circuit court rejected the regulation's

interpretation even though the statute was silent on the question. This Court reversed, holding that the EPA's interpretation was entitled to judicial deference; the circuit court could not substitute its own definition in place of the EPA's interpretation. *Chevron* provides a two-step approach for courts to use in interpreting regulations: (1) determine whether the statute addresses the precise question before it; and (2) if it does not, the court must defer to the agency's interpretation.

3. After *Chevron*, the question arose whether *Chevron* deference is required with respect to all agency rulings. This Court provided clarification in *United States v. Mead Corp.*, 533 U.S. 218 (2001). In *Mead*, the Court considered the deference appropriate to a Customs Service ruling that was issued not pursuant to an express grant of legislative authority, but under the general authority of the agency to make rules interpreting statutes the agency is charged to administer. The Court held that the ruling, which was not promulgated pursuant to notice-and-comment proceedings, was not entitled to *Chevron* deference, but was entitled to "respect according to its persuasiveness," pursuant to *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944). The *Skidmore* factors relevant in determining whether an agency pronouncement is entitled to a court's deference are "the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control." *Skidmore*, *supra*, at 140. A significant factor in determining that the Customs ruling was not entitled to *Chevron* deference was the fact that Customs offices issued over 10,000 classification rulings a year.

In *Mead*, at 229 (citations omitted), the Court characterized the deference required by *Chevron* as follows:

> This Court in *Chevron* recognized that Congress not only engages in express delegation of specific interpretive authority, but that "sometimes the legislative delegation to an agency on a particular question is implicit." Congress, that is, may not have expressly delegated authority or responsibility to implement a particular provision or fill a particular gap. Yet it can still be apparent from the agency's generally conferred authority and other statutory circumstances that Congress would expect the agency to be able to speak with the force of law when it addresses ambiguity in the statute or fills a space in the enacted law, even one about which "Congress did not actually have an have intent" as to a particular result. When circumstances implying such an expectation exist, a reviewing court has no business rejecting an agency's exercise of its generally conferred authority to resolve a particular statutory ambiguity simply because the agency's chosen resolution seems unwise, but is obliged to accept the agency's position if Congress has not previously spoken to the point at issue and the agency's interpretation is reasonable.
>
> We have recognized a very good indicator of delegation meriting *Chevron* treatment in express congressional authorizations to engage in the process of

> rulemaking or adjudication that produces regulations or rulings for which deference is claimed. . . .

4. After *Mead*, the law remains uncertain as to the impact of these cases on interpretative Treasury regulations issued under the general grant of authority under § 7805(a). Circuit courts are inconsistent in the application of *Chevron* to § 7805(a) Treasury regulations. For example, some circuits conclude that *Chevron* deference applies. *Bankers Life and Casualty Co. v. United States*, 142 F.3d 973 (7th Cir. 1998); *Peoples Federal Savings and Loan Ass'n v. Commissioner*, 948 F.2d 289 (6th Cir. 1991). Others find that full *Chevron* deference is not appropriate. *E.I. du Pont de Nemours & Co. v. Commissioner*, 41 F.3d 130 (3d Cir. 1994); *Nalle v. Commissioner*, 997 F.2d 1134 (5th Cir. 1993); *Pacific First Federal Savings Bank v. Commissioner*, 961 F.2d 800 (9th Cir. 1992). A further complication is that this Court has relied on *National Muffler* in post-*Chevron* tax cases without mentioning *Chevron*. *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200 (2001); *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554 (1991). The Court has not expressly stated whether the deference accorded under *National Muffler* is the same as full *Chevron* deference accorded legislative regulations, or whether the *National Muffler* deference is a heightened form of *Skidmore* deference. The Seventh Circuit states that it "see[s] no reason that nontax regulations issued with notice and comment should receive Chevron deference while tax regulations promulgated with the same procedures receive something different." *Bankers Life*, *supra* at 982. The uncertainties in recent decisions are discussed in John F. Coverdale, *Chevron's Reduced Domain: Judicial Review of Treasury Regulations and Revenue Rulings After Mead*, 55 Admin. L. Rev. 39 (2003).

5. This case presents an additional unresolved issue: the degree of deference or respect to be accorded agency regulations that interpret an applicable statutory provision in a slightly different context. The regulations specifically contain the agency's interpretation of the governing statutory provisions, but by their terms, the regulations are of limited scope. Thus, the unresolved question is what deference or respect is required to be applied to Treasury regulations where the regulations: (1) are promulgated after notice and comment under the express grant of Congressional authority under § 7805(a)[9]; (2) interpret precisely the same statute and issue in dispute; and (3) promote the same policy objective (i.e., properly measure foreign-source income); but (4) do not extend to the taxpayer, by their terms. Clearly related to this question is whether the agency is required to follow the decisions made in regulations where it addresses the same statute and policy considerations in another context.[10]

We submit that regulations having these characteristics are entitled to *Chevron* or *National Muffler*

---

[9] The § 953 regulations were first proposed in a Notice of Proposed Rulemaking published at 29 Fed. Reg. 10,603 (1964) and, after comments, were finalized in T.D. 6781, 29 Fed. Reg. 18,201 (1964).

[10] The Internal Revenue Service has issued a revenue ruling consistent with respondent's position, but contrary to the regulations. Rev. Rul. 68-622, 1968-2 C.B. 298. However, in its cross-motion for summary judgment in the lower court respondent stated that it did not rely on the ruling in any way. In any event, the ruling is not entitled to *Skidmore* deference because it conflicts with the regulations and offers no reasoning in support of its conclusion.

deference, or, at a minimum, *Skidmore* respect.[11] The courts, the Internal Revenue Service and the taxpayer are not operating on a clean slate. The precise issue of statutory construction has been addressed and resolved by the Treasury Department in a formal rulemaking procedure. Under these circumstances, there should be a compelling reason for a court to depart from the interpretation of the statute in the regulations even though the issue involves a taxpayer that is technically beyond the scope of the regulations. Otherwise, the validity and authority of the interpretation embodied in the regulations will be undermined; unwarranted inconsistent treatment of taxpayers will result. Avoidance of this type of inconsistency is one of the reasons cited by the Court for granting *Skidmore* respect to agency determinations. Accordingly, we respectfully request that the Court grant certiorari and clarify the scope of *Chevron*, *National Muffler* and *Mead/Skidmore* in these circumstances.

6. Neither the court of appeals nor respondent should ignore relevant regulations. There is no statute or regulation that addresses explicitly how a life insurance company computes the foreign tax credit.[12] The only

---

[11] "There is general consensus that courts should give some weight to general authority regulations." John F. Coverdale, *Court Review of Tax Regulations and Revenue Rulings in the Chevron Era*, 64 Geo. Wash. L. Rev. 35, 67 (1995). The reasons given include: (1) the regulations are the official published position of the agency administering the tax law; (2) the regulations "represent the judgment of experts experienced in the interpretation of the tax laws"; and (3) deference promotes the uniform application of the tax laws. Coverdale, *supra*, at 67-68.

[12] Upon considering the effect of several statutes on the foreign tax credit, the Second Circuit observed:

> When there is nothing to indicate that any of the

regulatory guidance that interprets the question of whether the § 809(a) policyholders' share must be excluded from gross investment income or deducted against insurance income is contained in the subpart F regulations under § 953. These regulations, which explicitly provide that the § 809(a) policyholders' share should be allocated to U.S. and foreign risks as a *deduction* and not excluded from income, are entitled to judicial deference.

B. The Court of Appeals' Judgment Is Wrong

The court of appeals' decision is wrong in many respects. The errors stem from the appeals courts' reliance on the label placed on the policyholders' share in § 809. The court of appeals should have addressed the proper question: how to compute Travelers' foreign-source taxable income, which involves the interplay of §§ 809, 810, 841, 901, 904 and 907, as well as the sourcing rules of §§ 861-864. In other words, the computation of gain from operations in Travelers' life insurance company taxable income was not in issue. Rather, the issue was how to take into account the policyholders' share for purposes of computing the numerator of Travelers' foreign tax credit limitation fraction. Furthermore, the court of appeals was wrong in ignoring (1)

> draftsmen or legislators responsible for any of the provisions here involved ever considered the problem before us, it is pure fiction to conclude that, because Congress passed certain broad legislation . . . , Congress must have "intended" certain results under the foreign tax credit provisions. This type of analysis imputes to the legislators an infinity of knowledge and a unity of intention which they obviously did not have.

Associated Telephone and Telegraph Co. v. United States, 306 F.2d 824, 829 (2d Cir. 1962).

the substance of the subchapter L rules for the computation of life insurance company taxable income, and (2) the fact that § 810 voided the exclusion. The § 810 adjustment affects taxable income, and the sourcing rules require that the adjustment be taken into account in computing the foreign tax credit for the credit to function properly to avoid double taxation. Finally, the court of appeals' decision to restrict Travelers' ability to address the remaining unbriefed and undecided issues is wrong.

1. Because it limited its inquiry to § 809, the court of appeals did not consider the purpose of the item being computed – the foreign tax credit under §§ 901 and 904. The purpose of the credit is to reduce or eliminate the double taxation that would result if both the foreign country where the income was generated and the United States were to tax the same income. *Burnet v. Chicago Portrait Co.*, *supra*; Owens, *supra*. The decision of the court of appeals results in a confiscatory double tax that the foreign tax credit is designed to prevent. *See American Chicle Co. v. United States*, 316 U.S. 450, 452 (1942). The undisputed evidence in the record demonstrates the double tax. Travelers showed that the effective rate of the taxes paid to Indonesia varied from approximately 33% to 62%. The highest U.S. tax rate applicable to Travelers from 1975 to 1980 ranged from 46% to 48%. By Travelers' computation, the approximate rate of U.S. plus Indonesian tax on the Indonesian net income, after the credit allowed by respondent (and the court of appeals' judgment), varies from 63% to 89% for the years in issue. Congress could not have intended this unfair result.

2. Moreover, double taxation is not required by the purpose of the policyholders' share rules, i.e., to impose tax indirectly on all investment income. S. Rep. No. 291 at 17. *See Bank of America v. United States*, 680 F.2d 142, 147

(Ct. Cl. 1982). When Congress enacted the life insurance taxation rules in 1959, the foreign tax credit had been in effect for forty years. Had Congress intended that the policyholders' share rules actually deny a foreign tax credit for foreign taxes paid on foreign investment income, it would have so indicated.

3. The undisputed evidence in the lower court demonstrates that the policyholders' share is not a *real* exclusion from taxable income under § 809(a).[13] Rather, the "exclusion" is voided under § 810 and restored to taxable income through a dollar-for-dollar offsetting adjustment to reserves that are otherwise fully deductible. The only net economic impact of these policyholders' share rules is to pose a tax indirectly on certain tax-exempt interest by denying a reserve deduction. In other words, the "exclusion" is in reality not an exclusion at all. The sole purpose of the statutory scheme is to disallow the double benefit that would arise if a life insurance company both claimed a reserve deduction and excluded tax-exempt interest. H. Rep. No. 34, *supra*, at 14.

4. In addition, even if the court of appeals' interpretation were sustained, the court of appeals erred in its judgment by improperly limiting the issues for remand. If respondent's view of the policyholders' share as an exclusion for purposes of the foreign tax credit is upheld, several issues result. These issues were not considered by the lower court, due to its holding for Travelers. Thus, the judgment of the court of appeals should be overruled to the extent it denies

---

[13] Travelers demonstrated in the record below that its Indonesian income was fully included in worldwide taxable income.

Travelers its day in court on issues that have not been briefed or decided.

CONCLUSION

For the foregoing reasons, the Court should grant this petition for writ of certiorari, reverse the judgment of the court of appeals, and reinstate the judgment of the lower court.

Respectfully submitted,

PETER H. WINSLOW
Counsel of Record
BIRUTA P. KELLY
GREGORY K. OYLER
Attorneys
Scribner, Hall & Thompson, LLP
1875 Eye Street, N.W.
Suite 1050
Washington, D.C. 20006-5409
(202) 331-8585

Counsel for Petitioner

APPENDIX

United States Court of Appeals for the Federal Circuit

01-5137

THE TRAVELERS INSURANCE COMPANY,

Plaintiff-Appellee,

v.

UNITED STATES,

Defendant-Appellant.

Peter H. Winslow, Scribner, Hall & Thompson, LLP, of Washington, DC, argued for plaintiff-appellee.

Edward T. Perelmuter, Attorney, Tax Division, Department of Justice, of Washington, DC, argued for defendant-appellant. With him on the brief were Eileen J. O'Connor, Assistant Attorney General; David English Carmack, and David I. Pincus, Attorneys.

Appealed from: United States Court of Federal Claims

Senior Judge Loren A. Smith

United States Court of Appeals for the Federal Circuit

01-5137

THE TRAVELERS INSURANCE COMPANY,

Plaintiff-Appellee,

v.

UNITED STATES,

Defendant-Appellant.

DECIDED: September 16, 2002

Before SCHALL, DYK, and PROST, Circuit Judges.

DYK, Circuit Judge.

This federal income tax refund case has been pending in the Court of Federal Claims for over a decade. It presents two issues, each of which relates to special rules for the taxation of life insurance companies, such as the Travelers Insurance Co. ("Travelers" or "taxpayer"), the appellee in this case. The first issue is whether the policyholders' share of income should have been excluded from "taxable income" for purposes of computing the limitation on the foreign tax credit in section 904 of the Internal Revenue Code, 26 U.S.C. § 904 (1976). For life insurance companies, "taxable income" is defined in terms of taxpayer's "life insurance company taxable income" ("LICTI"). Id. § 802. We hold that

Congress explicitly provided for the exclusion of the policyholders' share from LICTI in 26 U.S.C. §§ 804(a)(1) and 809(a)(1) (1976), and accordingly reverse the decision of the Court of Federal Claims to the contrary.

The second issue is whether, under 26 U.S.C. § 446 (1976), the Internal Revenue Service ("IRS" or "Service") properly determined that the taxpayer's method of translating foreign currency profits and losses from Canadian branch operations into United States dollars failed to "clearly reflect income." We hold that the Court of Federal Claims erred in declining to defer to the IRS determination, and that the taxpayer has not shown that the IRS abused its discretion. Accordingly, we reverse the decision of the Court of Federal Claims to the contrary.

BACKGROUND

Taxpayer is a stock life insurance company, which writes various forms of life and accident insurance. This case presents two issues concerning the taxpayer's income tax liability—one relating to the foreign tax credit and the other concerning the taxation of income from taxpayer's Canadian branch operations.

I The Foreign Tax Credit Issue

In 1970, taxpayer entered into an agreement with an offshore drilling company under which taxpayer received a 3% interest in an Indonesian oil exploration and drilling joint venture. Every year between 1975 and 1980, taxpayer received net income from its participation in the joint venture. During those years, taxpayer paid taxes to Indonesia on the income it earned from the joint venture and claimed foreign tax credits under sections 841 and 901 of the Internal

Revenue Code, 26 U.S.C. §§ 841, 901 (1976). In all relevant respects, the pertinent sections of the Tax Code were unchanged between 1975 and 1980. For ease of reference, this opinion refers to the 1976 version of the Tax Code. Many of the statutory provisions involved in this case have been revised or repealed since 1980.

Computation of LICTI

In order to understand the foreign tax credit issue, it is necessary to understand the method by which the income tax of life insurance companies was computed. Instead of using the familiar concept of "taxable income," 26 U.S.C. § 11 (1976), as the base, the Code provided that in the case of life insurance companies the base was to be "life insurance company taxable income" ("LICTI"), id. § 802. During the relevant taxable years, taxpayer computed its LICTI under provisions enacted in the Life Insurance Company Tax Act of 1959, Pub. L. No. 86-89, 73 Stat, 112 (1959), which were codified in former sections 801 to 820 of the Code, 26 U.S.C. §§ 801-820. Under those provisions, taxpayer initially was required to compute both its "taxable investment income" and its "gain from operations." Id. § 802(b). To compute its taxable investment income, the company began with its gross investment income, an item that included traditional investment income such as interest, dividends, rents, and royalties, as well as income from non-insurance business enterprises, such as oil-related income. Id. § 804(b). The company then subtracted from its gross investment income its investment expenses. The balance was referred to as "investment yield." Id. § 804(c).

The next computation involved the division of "investment yield" into a "policyholders' share" and the "company's share." Id. § 804(a). The first step in this

computation was the development of a fraction, which was the amount of investment income needed for policyholder and other contract liability requirements (i.e., the amount that must be added to reserves), divided by the total investment yield. This fraction was then multiplied by "each and every item of investment yield," id. § 804(a)(1), to obtain the policyholders' share of that item. The policyholders' share of each item was then excluded from income. Id. § 804(c)(1). The company's taxable investment income was the sum of the company's share of each item and the net capital gain. Id. § 804(a)(2).

"Gain from operations," in contrast to taxable investment income, consisted of all of the company's income--investment income and underwriting income. See id. §§ 809(b), (c) & (d); United States v. Atlas Life Ins. Corp., 381 U.S. 233, 235 n.2 (1965). Like the computation of taxable investment income, the investment income portion of gain from operations was only "the life insurance company's share of each and every item of investment yield[.]" 26 U.S.C. § 809(b)(1)(A). The policyholders' share of each and every item of investment yield was again excluded. Id. § 809(a)(1).

After computing its "taxable investment income" and "gain from operations," the company compared the two figures. If the company's gain from operations was less than its taxable investment income (because, for example, the company had underwriting losses), its tax base (LICTI) was gain from operations. Id. § 802(b)(1). On the other hand, if the company's gain from operations was greater than its taxable investment income, its tax base (LICTI) was taxable investment income plus one half of the excess of gain from operations over taxable investment income. Id. § 802(b)(2).

Although the method of computing taxable income was complex, the central fact for present purposes is that the policyholders' share of "taxable investment income" and "gain from operations" reduced taxable income (LICTI).

The Foreign Tax Credit Provisions

For insurance companies, the foreign tax credit was authorized by 26 U.S.C. § 841 (1976), which incorporated the general foreign-tax-credit provision of 26 U.S.C. § 901 (1976). Section 841 provided that:

> The taxes imposed by foreign countries or possessions of the United States shall be allowed as a credit against the tax of a domestic insurance company subject to the tax imposed by section 802 [on LICTI] . . . to the extent provided in the case of a domestic corporation in section 901 (relating to foreign tax credit).

26 U.S.C. § 841 (1976). Section 901 authorized a taxpayer to claim the credit "subject to the limitation of section 904 . . . ." Id. § 901(a). Section 904(a), in turn, provided:

> The total amount of the credit taken under section 901(a) shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year.

Id. § 904(a). As applied to life insurance companies, section 841 provided that "life insurance company taxable income" was to be used as "taxable income" for purposes of the foreign tax credit. Id. § 841. The section 904 "limitation" may be expressed by the following formula, in which the right-hand side of the formula is referred to hereafter as the "section 904 fraction":

$$\text{United States Income Tax Liability before Application of Foreign Tax Credit} \times \frac{\text{Foreign Source LICTI}}{\text{Worldwide LICTI}}$$

In cases involving oil-related income, section 907(b) provided that the section 904 limitation was to be applied separately for "foreign oil related income" and "other taxable income." Id. § 907(b)(1).[1]

Proceedings Below

The central dispute in the Court of Federal Claims[2] was whether the policyholders' share of both foreign source LICTI and worldwide LICTI, which respectively comprise the numerator and denominator of the section 904 fraction,

---

[1] There is also a separate section 907(a) limitation applicable to "foreign oil and gas extraction income," 26 U.S.C. § 907(a) (1976), but the application of that limitation apparently has no effect here. As the Court of Federal Claims noted, "Under defendant's computation, [s]ection 907(b) imposes the greatest restriction upon Travelers' allowable foreign tax credit related to the Indonesian oil venture. Thus, [s]ection 907(b) provides the lesser foreign tax credit under [s]ection 901(a), and is the operative limitation in this case." Travelers Ins. Corp. v. United States, 28 Fed. Cl. 602, 608 (1993).

[2] When the complaint was first filed on August 19, 1988, the Court of Federal Claims was known as the United States Claims Court.

should be treated as an exclusion or a deduction. If the policyholders' were an exclusion, both the taxpayer and government agreed that the policyholders' share should be excluded from the numerator and denominator of the section 904 fraction, and that no refund was due. On the other hand, if the policyholders' share were a deduction, the taxpayer argued that it should be ignored in calculating the numerator – foreign source LICTI – because the deduction was properly attributable to United States operations under the sourcing rules of 26 C.F.R. §§ 861-863 (1977).[3] But the policyholders' share, in the taxpayer's view, was still properly deducted from the denominator to compute worldwide LICTI.[4]

---

[3] Specifically, taxpayer cited Treas. Reg. § 1.861-8(a), which provides in pertinent part:

> (1) Scope. Sections 861(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources within the United States after gross income from sources within the United States has been determined. Sections 862(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources without the United States after gross income from sources without the United States has been determined. This section provides specific guidance for applying the cited Code sections [which include section 904] by prescribing rules for the allocation and apportionment of expenses, losses, and other deductions (referred to collectively in this section as "deductions") of the taxpayer.

26 C.F.R. § 1.861-8(a) (1977) (emphasis added).

[4] Even if the policyholders' share were a deduction, the government argued that it should be deducted from foreign source LICTI in computing the section 904 fraction.

On April 30, 1993, the Court of Federal Claims issued its first opinion, granting partial summary judgment to taxpayer on the foreign tax credit issue. Travelers Ins. Corp. v. United States, 28 Fed. Cl. 602 (1993). In its opinion, the Court of Federal Claims acknowledged that "[b]oth parties present coherent arguments for their positions on the nature of the policyholders' share." Id. at 612. The Court of Federal Claims recognized that under sections 804(a)(1) and 809(a)(1) of the Code the policyholders' share of income is "exclud[ed]" from both the numerator and denominator of the section 904 fraction. Id. at 607. However, relying almost entirely on section 810(b) of the Code, which relates to adjustment of life insurance company reserves, the court found that the statutory exclusion was in fact more "accurately viewed as a deduction." Id. at 613. This was so because the excluded amounts (the policyholders' share) reduced the amount of the reserves and hence the deduction allowed for addition to reserves. The overall effect was to increase LICTI after accounting for the deduction. The court reasoned, "[i]n reality, the policyholders' share exclusion is the required interest portion of the reserve deduction which is fully recouped by the corresponding decrease in the year-end reserves under [s]ection 810." Id. at 613. The court then concluded that this "deduction" was "properly allocated to Travelers' gross income from its domestic insurance business and not to its Indonesian oil investment activities." Id. at 614. Therefore, the policyholders' share was improperly excluded from foreign source LICTI, which is the numerator of the section 904 fraction, but properly deducted from worldwide income to compute worldwide LICTI. Id. at 615.[5]

---

[5] The government correctly points out that the Court's assumptions as to the operation of the reserve provisions were not correct. In light of our disposition of this issue, we need not address the Court of Federal Claims'

II The Foreign Currency Translation Issue

The second issue concerns foreign currency translation. During the years 1977 through 1980, taxpayer derived income from insurance underwriting and investment operations in Canada. On its United States tax returns for those years, taxpayer calculated its taxable gain and income from its Canadian operations in Canadian dollars. Taxpayer combined those amounts with United States dollar amounts attributable to its other operations.[6] Taxpayer then made a "Canadian Exchange Adjustment" to the combined figure and reported that figure in United States dollars as part of the process of computing both its taxable investment income and its gain from operations for purposes of determining its LICTI for the relevant taxable years. In making this exchange adjustment, taxpayer used the current, end-of-the-year exchange rate.

On audit, the IRS recomputed taxpayer's LICTI by converting each line amount attributable to Canadian operations into United States dollars, combining that amount with the United States dollar amounts attributable to taxpayer's other operations, and reporting the total amount in United States dollars. In making this adjustment, the IRS concluded that taxpayer's method failed to clearly reflect its LICTI.

---

error in this respect.

[6] The parties dispute whether taxpayer combined the amounts before or after it translated the Canadian dollars to United States dollars. This dispute is irrelevant to the outcome of this appeal.

There is another significant difference between the IRS and the taxpayer concerning the treatment of the historical basis of certain taxpayer assets. The IRS converted the adjusted basis of Canadian bonds, mortgages, and joint ventures from Canadian dollars to United States dollars using historical exchange rates (i.e., the rates in effect at the time of the original acquisition of the asset). The government urges that this historical exchange rate was required by section 805(b)(4), which provides that "the amount attributable to— . . . (B) any other asset shall be the adjusted basis, of such asset for purposes of determining gain on sale or other disposition." 26 U.S.C. § 805(b)(4)(B) (1976).

Taxpayer paid the additional tax resulting from the Commissioner's determinations and filed a refund claim with the IRS. After the IRS denied the refund claim, taxpayer filed this refund suit claiming that the IRS had erred in substituting its own accounting method for the method employed by taxpayer.

On March 21, 1996, the Court of Federal Claims issued another opinion. In again granting partial summary judgment for the taxpayer, the Court of Federal Claims noted that "[i]t is not the intention of this court to modify or limit the amount of latitude that has been consistently accorded the Secretary in determining what method of accounting will accurately reflect a taxpayer's income." Travelers Ins. Corp. v. United States, 35 Fed. Cl. 138, 141 (1996). Nonetheless, the court concluded that no deference was due the IRS determination for two reasons. First, the court found that the IRS abused its discretion by imposing its own accounting method without making the necessary formal and explicit determination that the taxpayer's method did not clearly reflect income. Id. at 145-46. Second, the court found:

> De novo review of the taxpayer's method of accounting may, at first blush, seem to contradict the express language of section 446(b) because implicit in the phrase "in the opinion of the Secretary" is the concept of Secretarial discretion. Upon further examination of the placement of that language within the section, however, it is clear that section 446(b) contemplates two different levels of judicial review. The first determination to be made by the Secretary—whether the taxpayer's regularly used method of accounting clearly reflects income—is not subject to the Secretary's opinion and therefore is to be reviewed de novo. The second determination—what alternative method does clearly reflect income—is subject to the "opinion of the Secretary" and therefore must be accorded the significant degree of deference normally accorded to an administrative agency by a court.

Id. at 141 (citations omitted) (emphasis added).

The court then examined the two methods of conversion generally recognized by the IRS: the "profit and loss" and the "net worth" methods. Id. at 142. The "profit and loss" method involves computing net income attributable to foreign branch operations in foreign currency and then using end-of-the-tax-year exchange rates to translate the income into United States dollars. Id. The "net worth" method translates the balance sheet net worth, not just the income of the foreign branch. The increase in net worth is treated as taxable income. Id. As an example of a profit and

loss method, the court identified Revenue Ruling 75-107, which provides in pertinent part that "[t]he balance of the net profits, expressed in [foreign] Country Y's units should be converted into United States money at the rate of exchange as of the end of the taxable year, regardless of the fact that the profits may not have been remitted to M [a domestic corporation]." Id.; Rev. Rul. 75-107, 1975-1 C.B. 32. The court then concluded that "[t]he Travelers' Method, which computes net gain or loss in Canadian currency and then converts this amount to U.S. dollars by the end-of-the-year exchange rate," Travelers, 35 Fed. Cl. at 142, was "essentially the same as the profit and loss method described in Revenue Ruling 75-107," 33 Fed. Cl. at 143. The court accepted this revenue ruling as evidence that Travelers' Method clearly reflected income. Id.

The court further concluded that the government had "not offered any conclusive evidence in support of the Service's determination that the Travelers' Method does not clearly reflect income," id. at 144, and more specifically, that "the government has failed to show any basis for its position that the Travelers' Method of accounting did not accurately reflect plaintiff's income for taxable years 1977 through 1980," id. at 145. In light of taxpayer's consistent use of this accounting method in addition to the IRS's previous acceptance of the method, the court held that the IRS exceeded the scope of section 446(b) by requiring taxpayer to use the Service Method. Id. at 145. In addressing the foreign currency translation issue, the Court of Federal Claims did not discuss section 805.

When the Court of Federal Claims entered a final judgment on June 22, 2001, the United States appealed. We have jurisdiction pursuant to 28 U.S.C. § 1295(a)(3).

DISCUSSION

The issues in this case are issues of law, which we review without deference to the Court of Federal Claims. Conti v. United States, 291 F.3d 1334, 1338 (Fed. Cir. 2002).

I The Foreign Tax Credit Issue

The clear language of the Code governs the foreign tax credit issue. Those provisions excluded the policyholders' share from LICTI.

As noted above, the "section 904 fraction" for purposes of the foreign tax credit is calculated in terms of taxpayer's "life insurance company taxable income" ("LICTI"), which is, in turn, calculated from the company's "taxable investment income" and "gain from operations." 26 U.S.C. §§ 841, 802(b) (1976). Section 804(a)(1) provides in pertinent part that "[t]he policyholders' share of each and every item of investment yield (including tax-exempt interest and dividends received) of any life insurance company shall not be included in taxable investment income." Id. § 804(a)(1) (emphasis added). Section 809(a)(1) similarly provides that "[t]he share of each and every item of investment yield (including tax-exempt interest and dividends received) of any life insurance company set aside for policyholders shall not be included in gain or loss from operations." Id. § 809(a)(1) (emphasis added). Thus, both provisions require that the policyholders' share be excluded from any computation of LICTI. Indeed, the Supreme Court recognized that the policyholders' share should be treated as an exclusion in United States v. Atlas Insurance Corp., 381 U.S. 233 (1965), stating: "Each item of investment income, including tax-exempt interest, is divided into a policyholders' share and a company's share. The policyholders' share is

added to the reserve, is excluded for tax purposes from the gross income of the company and is not taxed to either the company or the policyholders." Id. at 239 (emphasis added).

Taxpayer's primary argument, adopted by the Court of Federal Claims, is that any exclusion is only a temporary exclusion because the amount of the exclusion is later included in income by an adjustment to the reserves of the company. Thus, according to the taxpayer, this "exclusion" is in reality a "deduction" and that "deduction . . . is fully recouped by the corresponding decrease in the year-end reserves under [s]ection 810." Travelers, 28 Fed. Cl. at 613.[7]

The taxpayer misunderstands the function of section 810. "Life insurance reserves may be defined simply as that fund which, together with future premiums and interest, will be sufficient to pay future claims." Atlas, 381 U.S. at 236 n.3; accord 26 U.S.C. § 801(b)(1) (1976). Section 810 provides the method of computing its decreases or increases in annual reserves. A net decrease produces a corresponding increase in income, and a net increase produces a reserve deduction (and a decrease in income). 26 U.S.C. §§ 810(a), (b), 809(d)(2) (1976). Sections 810(a) and (b) provide parenthetically that prior to computation of any net decrease or increase in reserves, the items taken into account in

---

[7] An exclusion is defined as "[a]n item of income excluded from gross income." Black's Law Dictionary 585 (7th ed. 1999). On the other hand, a deduction is defined as "[a]n amount subtracted from gross income when calculating adjusted gross income, or from adjusted gross income when calculating taxable income." Id. at 422.

calculating the adjustment in reserves[8] must first be "reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1)." Id. § 810(a) and (b) (parentheses omitted). In other words, the policyholders' share is not taken into account in computing the increase or decrease in reserves. While the net effect of section 810 may be that the reserve deduction is decreased (and the taxpayer's income increased) in some circumstances by the policyholders' share, nothing in section 810 alters the provisions of sections 804 or 809 or converts an exclusion into a deduction.

As the Supreme Court has repeatedly recognized, "[c]ourts are not authorized to rewrite a statute because they might deem its effects susceptible of improvement." Badaracco v. Comm'r, 464 U.S. 386, 398 (1984); see also TVA v. Hill, 437 U.S. 153, 194-95 (1978). Here the taxpayer effectively requests that this court rewrite the Tax Code and treat a clearly labeled statutory exclusion as a deduction. Although the parties urge us to consider legislative history[9]

---

[8] These items include life insurance reserves, unearned premiums and unpaid losses included in total reserves, amounts necessary to satisfy obligations under insurance or annuity contracts, premiums received in advance, liabilities for premium deposit funds, and special contingency reserves. 26 U.S.C. § 810(c) (1976).

[9] If we were to consider the legislative history, we would conclude that it favors the government, not the taxpayer. All of the pertinent legislative history indicates that the policyholders' share was to be treated as an exclusion, not a deduction. See, e.g., S. Rep. No. 291, at 22 (1959), reprinted in 1959 U.S.C.A.N. 1575, 1596 ("Under your committee's amendments the required interest is omitted here because it is represented by the exclusion of that portion of the investment yield set aside for policyholders."). Indeed, the Court of Federal Claims noted that "the legislative history indicates that Congress specifically designated the

and policy considerations to determine the appropriate treatment of the policyholders' share, that is quite unnecessary. The Code is clear on its face, and we are not charged with rewriting it to convert an exclusion into a deduction based on the theory proposed by the taxpayer and adopted by the Court of Federal Claims. See Marsh Corp., Inc. v. United States, No. 02-5002, slip op. at 20 (Fed. Cir. Sept. 6, 2002); Phila. & Reading Corp. v. United States, 944 F.2d 1063, 1074 (3d Cir. 1991).[10]

Taxpayer relies on our decision in American Mutual Life Insurance Corp. v. United States, 267 F.3d 1344 (Fed. Cir. 2001), to urge that the policyholders' share is more analogous to a deduction than an exclusion. In American Mutual, the taxpayer argued that it received only a partial tax benefit from the deductions it took for increases in reserves. American Mutual, 267 F.3d at 1349. Consequently, the taxpayer urged that the corresponding reserve releases (i.e., reductions in reserves) in later tax years should not have been taxed as income, relying on the tax benefit rule codified at section 111.[11] Id. at 1349-50. The tax benefit rule ensures

---

policyholders' share as an exclusion after initially labeling it as a deduction." Travelers, 28 Fed. Cl. at 612.

[10] There is no inconsistency in this respect with the Supreme Court's decision in Atlas, which characterized the tax consequences of the Code for purposes of a constitutional issue, not for purposes of statutory construction. Atlas, 381 U.S. at 250-51.

[11] The tax benefit rule codified in section 111(a) provides: "Gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by this chapter." 26 U.S.C. § 111(a) (2000).

that "if a taxpayer takes a deduction attributable to a specific event, and the amount is recovered in a subsequent year, income tax consequences of the later event depend in some degree on the prior related tax treatment." Id. at 1346 (citation omitted). Affirming the Court of Federal Claims, we held that "because American Mutual received a benefit from the reserve deductions taken, it cannot resort to the tax benefit rule to exclude from income amounts corresponding to release of those reserves." Id. at 1354. Nothing in American Mutual remotely suggests that the policyholders' share is a deduction from reserves rather than an exclusion.[12]

Therefore, we conclude that the Code requires that the policyholders' share be treated as an exclusion from both the numerator and the denominator of the section 904 fraction, and we reverse the Court of Federal Claims' decision to the contrary.

II The Foreign Currency Translation Issue

A

We turn now to the second issue relating to foreign currency translation. Taxpayer argues that neither the Code nor the regulations required that a particular accounting method be used to translate the foreign currency into United

---

[12] Taxpayer also urges that the government has taken a different position on appeal to this court from the previous position that it took in its brief to this court filed in American Mutual. Even if its two positions were inconsistent, such an inconsistency is irrelevant, because our task is to determine the correct interpretation of the statute. In any event, the government did not say anything inconsistent in its brief in that case with its current position in this court.

States dollars. Taxpayer urges that its accounting method, which reported its Canadian branch taxable investment income and gain from operations in Canadian dollars and then applied year-end exchange rates to convert those figures into United States dollars, clearly reflected income because it was in essence the profit and loss method identified in Revenue Ruling 75-107. Revenue Ruling 75-107 provides in pertinent part that "[t]he balance of the net profits, expressed in [foreign] Country Y's units should be converted into United States money at the rate of exchange as of the end of the taxable year, regardless of the fact that the profits may not have been remitted to M [a domestic corporation]." Rev. Rul. 75-107, 1975-1 C.B. 32. The taxpayer acknowledges that its accounting method differs from Revenue Ruling 75-107 in that it is applied in two separate phases, which yield two exchange rate conversions, rather than just one phase as the revenue ruling suggests. However, the taxpayer argues that this difference is an immaterial variation.

The government urges that taxpayer's accounting method does not clearly reflect income and that the IRS has broad discretion to set aside a taxpayer's accounting method if it does not clearly reflect income. The government contends that the profit and loss method of accounting identified in Revenue Ruling 75-107 differs markedly from taxpayer's accounting method. Specifically, the government urges that taxpayer combined its taxable gain and income from its Canadian operations with the taxable gain and income from other United States operations without first translating the Canadian dollars to United States dollars. The government then states that taxpayer applied an unspecified "Canadian Exchange Adjustment" to the combined figure using the current, year-end exchange rates. The government argues that taxpayer's method fails to clearly reflect income and contends that the Court of Federal Claims erred by

substituting its judgment for that of the IRS when it concluded that taxpayer's accounting method clearly reflected income.

A second foreign currency translation issue concerns the calculation of the basis of certain assets. The government urges that section 805(b)(4) dictates that the taxpayer should have used historical rather than current year-end exchange rates for the foreign currency translation of certain assets. The taxpayer urges that section 805(b)(4) does not govern this case because "[t]he purpose of section 805(b)(4) is to quantify assets to determine the current earnings rate," App. Br. at 59, and it does not address whether historical or current exchange rates should be used in calculating the basis of those assets. As noted above, the Court of Federal Claims failed to address this issue.

B

Initially, we note that the decision of the Court of Federal Claims on the foreign currency translation issue rests on two quite mistaken premises concerning the authority of the IRS acting pursuant to section 446 of the Code. Section 446 provides in pertinent part:

> (a) General Rule
>
> Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.
>
> (b) Exceptions
>
> If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be

> made under such method as, in the opinion of the Secretary, does clearly reflect income.

26 U.S.C. § 446 (1976) (emphasis added).

First, the Court of Federal Claims erred when it concluded that no deference was due the IRS determination because the IRS had not made an explicit determination that the Service Method clearly reflected income. Travelers, 35 Fed. Cl. at 145. There is no requirement in section 446 that the IRS make explicit findings identifying section 446 as the source of its authority. Such a determination is implicit when the IRS substitutes its method for the method of the taxpayer.

Second, the Court of Federal Claims, following its own decision in Mulholland v. United States, 28 Fed. Cl. 320, 335 (1993), erred in applying a de novo standard of review as to whether the taxpayer's accounting method clearly reflected income within the meaning of section 446(b). See Travelers, 35 Fed. Cl. at 141. We find no support for the Court of Federal Claims' position in the language of the statute. Under section 446, the Commissioner has broad discretion to set aside a taxpayer's accounting method if he believes that it does not clearly reflect income. Over 70 years ago, in Lucas v. American Code Corp., 280 U.S. 445 (1930), the Supreme Court emphasized the broad discretion that the Service should be given to interpret the Code, including provisions such as the precursor to section 446:

> And the direction that net income be computed according to the method of accounting regularly employed by the taxpayer is expressly limited to cases where the Commissioner believes that the accounts clearly reflect the net income. Much latitude

> for discretion is thus given to the administrative board charged with the duty of enforcing the Act. Its interpretation of the statute and the practice adopted by it should not be interfered with unless clearly unlawful.

Id. at 449. See also Thor Power Tool Corp. v. Comm'r, 439 U.S. 522, 532 (1979) (indicating that section 446, inter alia, "vest[s] the Commissioner with wide discretion in determining whether a particular method of inventory accounting should be disallowed as not clearly reflective of income.").

So too, our prior decisions reject a de novo standard of review. See LaCrosse Footwear, Inc. v. United States, 191 F.3d 1372, 1379 (Fed. Cir. 1999) (finding that the Commissioner did not abuse his discretion when he concluded that taxpayer's accounting method did not clearly reflect income); Morgan Guar. Trust Corp. of N.Y. v. United States, 585 F.2d 988, 997 (Ct. Cl. 1978) (finding that the Commissioner abused his discretion when he rejected taxpayer's accounting method). Accordingly, the Court of Federal Claims must accord substantial deference to the IRS determination that the taxpayer's method does not clearly reflect income.

C

Applying the correct standard, we conclude that the IRS determination must be sustained. The taxpayer here made no showing that the IRS abused its discretion in determining (1) that the taxpayer's method did not clearly reflect income and (2) substituting its own methodology. The IRS properly required the use of the established profit and loss method. The fact that the taxpayer's methodology may

have been "conceptually similar" to or "essentially the same as" the IRS-approved method is irrelevant. Contrary to the Court of Federal Claims' decision, it is also of no moment that the IRS did not challenge the taxpayer's methodology in each year. The IRS is not bound by its earlier position. See Dickman v. Comm'r, 465 U.S. 330, 343 (1984); Caldwell v. Comm'r, 202 F.2d 112, 115 (2d Cir. 1953). We have considered and reject the taxpayer's other challenges to the IRS determination. However, one aspect of the IRS determination requires further comment.

The government contends that section 805 compels that the basis of bonds, mortgages, and joint venture assets be computed at historical rather than current, year-end exchange rates. We are unable to find any such requirement in section 805.

Section 805 provides in pertinent part:

> (b) Adjusted reserves rate and earnings rates.
> . . . .
> (4) Assets
> For purposes of this part, the term "assets" means all assets of the company (including nonadmitted assets), other than real and personal property (excluding money) used by it in carrying on an insurance trade or business. For purposes of this paragraph, the amount attributable to—
> (A) real property and stock shall be the fair market value thereof, and
> (B) any other asset shall be the adjusted basis, of such asset for purposes of determining gain on sale or other disposition.

26 U.S.C. § 805 (1976) (emphasis added). Section 805(b)(4) describes how to quantify assets to determine the adjusted reserves rates and earnings rates for any taxable year. Nothing in section 805 specifies whether, for income tax purposes, the basis of assets for computing capital gain or loss should be computed using historical or current, year-end exchange rates. Section 805 does not specifically define "adjusted basis." That section evidently contemplates use of standard basis provisions. Section 1011(a), a generally applicable section of the Code, simply provides that the "adjusted basis" shall be determined under section 1012. Id. § 1011(a). Section 1012(a), in turn, provides that "[t]he basis of property shall be the cost of such property . . . ." Id. § 1012. Thus, section 805 does not specify the use of a particular basis for foreign branch assets of life insurance companies purchased with foreign currency. We hold that section 805 does not require the result for which the government argues—namely, determining the basis of bonds, mortgages, and joint venture assets for income tax purposes by reference to historical exchange rates.[13] Nonetheless, we conclude that the IRS could properly, as an exercise of discretion, require the use of historical exchange rates in order to capture the gain attributable to the purchase of capital

---

[13] We also note that the foreign currency cases on which the government relies do not involve capital assets held by foreign branch operations. See, e.g., KVP Sutherland Paper Corp. v. United States, 344 F.2d 377 (Ct. Cl. 1965); Bennett's Travel Bureau, Inc. v. Comm'r, 29 T.C. 350 (1957); The Joyce-Koebel Corp. v. Comm'r of Internal Revenue, 6 B.T.A. 403 (1927); Appeal of Bernuth Lembcke Corp., 1 B.T.A. 1051 (1925).

assets in depreciated foreign currency, which have since increased in value.[14]

CONCLUSION

For the above reasons, we reverse the decision of the Court of Federal Claims on both the foreign tax credit and the foreign currency translation issues.

COSTS

No costs.

---

[14] We note that these foreign currency issues are now governed by legislation enacted in the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986). The Conference Committee Report on that legislation noted that under the law existing before the new statute for purposes of the net worth method, historical exchange rates were to be used. H.R. Conf. Rep. No. 99-841, at II-674 (1986), reprinted in 1986 U.S.C.C.A.N. 4075, 4762.

In the United States Court of Federal Claims

Nos. 494-88T and 262-89T

Filed: April 30, 1993

* * * * * * * * * * * * * * * * * * *

TRAVELERS INSURANCE COMPANY,

Plaintiff,

v.

THE UNITED STATES,

Defendant.

* * * * * * * * * * * * * * * * * * *

Tax; Summary Judgment; Life Insurance Company Taxation; Foreign Tax Credit Limitation; Foreign Oil Investment Income

---

FILED
APR 30 1993
U.S. COURT OF
FEDERAL CLAIMS

E. Victor Willetts, Jr., Washington, D.C., with whom was *Peter H. Winslow*, and *Biruta P. Kelly*, for plaintiff.

Stuart J. Bassin, Washington, D.C., with whom was *David Gustafson*, Assistant Chief, *Mildred L. Seidman*, Chief, Claims Court Section, Tax Division, United States Department of Justice, and *Shirley D. Peterson*, Assistant Attorney General, for defendant.

OPINION

SMITH, Chief Judge

These consolidated cases, involving claims for refund of $9,965,157.00 in income taxes and interest for the tax years 1975 through 1980, are before the court on the parties' cross-motions for partial summary judgment. The pending motions involve the determination of plaintiff's foreign source taxable income for purposes of its allowable credit for taxes paid to the government of Indonesia for the years 1975 through 1980. Plaintiff contends that defendant improperly computed its foreign investment income by reference to the life insurance company income tax provisions of the Internal Revenue Code. The government maintains that its method of computation of plaintiff's foreign investment income was correct, except for two years in which defendant claims it erred in plaintiff's favor. Thus, the government claims it is entitled to an offset for those years. After careful consideration of the parties' briefs, oral arguments, supporting documentation, the highly complex statutory scheme, and the applicable precedent, the court concludes that plaintiff must prevail.

FACTS

Plaintiff, the Travelers Insurance Company (Travelers)[1], is a stock corporation organized and existing

---

[1] During the tax years in issue, Travelers filed a consolidated tax return for a group of companies which included plaintiff, Travelers Insurance Company, Travelers Life Insurance Company, and Travelers Life and Annuity Company. Travelers Insurance Company was the investor in the Indonesian oil venture at issue and is referred to herein as "Travelers."

under the laws of the state of Connecticut. Travelers is engaged in the business of writing various forms of life and accident insurance. Therefore, during the tax years in question, plaintiff was taxed under the provisions of Subchapter L, Part 1, Section 801 *et seq.*, of the Internal Revenue Code of 1954 (IRC).[2]

In 1970, as part of its investment activities, plaintiff entered into an agreement with the Reading & Bates Offshore Drilling Company (R&B), whereby R&B assigned 75 percent of its 4 percent interest in an Indonesian oil exploration and drilling joint venture to Travelers. Under the agreement, Travelers provided 75 percent of R&B's required contribution in the joint venture and received 75 percent of R&B's share of the joint venture's proceeds. The Indonesian oil venture was organized as a production sharing agreement. Pursuant to the terms of the organizational documents, Travelers filed a Section 761(a) election with the IRS not to be treated as a partnership for purposes of IRS Code Subchapter K. On its federal income tax returns from 1975 through 1980, Travelers reported its share of the oil venture's gross income and claimed a foreign tax credit for its share of the taxes paid to Indonesia.[3] The parties agree that Travelers is entitled to a foreign tax credit for the Indonesian taxes but disagree on its method of computation and hence its amount.

---

[2] Unless otherwise indicated, the code provisions discussed in this opinion refer to the Internal Revenue Code as in effect in 1975 through 1980. Most of the statutes involved in this case have been revised or repealed since 1980.

[3] For purposes of the foreign tax credit, IRC Section 907(a) generally reduces the amount of any foreign oil and gas extraction taxes to be taken into account to an amount equal to the foreign oil and gas extraction income (FOGEI) times the Section 11 United States corporate tax rate.

On its tax returns for the years 1975 through 1978, Travelers determined its foreign tax credit limitation by excluding a policyholders' share from its Indonesian oil investment yield. To arrive at its foreign source taxable income, Travelers went through three steps:

1. foreign investment yield
- section 809(a) policyholders' share
= foreign taxable investment income

2. foreign investment yield
- sections 804-06 policyholders' share
= foreign gain from operations

3. foreign taxable investment income
+ 50% of the difference of foreign gain from operations over foreign taxable investment income
= foreign source taxable income

Thus, for example, Travelers' computed its 1975 foreign tax credit in the following manner:

1. Indonesian oil investment yield	$3,074,936
- policyholders' share of 66.82%	2,054,970
- small business deduction[4]	
= Indonesian taxable investment income	$1,019,966

[4] Because the small business deduction is comparatively minuscule, the parties ignore it in their briefs.

2. Indonesian oil investment yield	$3,074,936
- policyholders' share of 47.52%[5]	1,461,370
- small business deduction	
= Indonesian taxable investment income	$1,613,566
3. taxable investment income	$1,019,966
+ 50% of Indonesian gain from operation over taxable investment income	296,800[6]
= foreign source taxable income	$1,316,766[7]

In the years 1979 and 1980, instead of the above method, plaintiff used the "within and without" method of calculating its taxable income. Under this method, plaintiff's

---

[5] The policyholders' shares vary based upon rates of interest assumed by the company and the calculations required by the U.S. Life Insurance Company Income Tax Return Form 1120L. As explained below, the Section 809 policyholders' share is the required interest portion of the reserves established for payment of claims and is calculated by multiplying the assumed interest rate by the mean of the reserve amount at the beginning and end of the taxable year. The Section 804-806 policyholders' share is determined by dividing policy liability requirements by the investment yield.

[6] This figure results from the subtraction of Travelers' Indonesian taxable investment income from its gain from the Indonesian oil operations and the multiplication of the difference by .5:

$1,613,566	593,600
1,019,966	x.5
593,600	296,800

[7] Defendant's Exhibit B 212. Travelers' calculations of its foreign tax credit for each of the tax years in question are set forth in the appendix to this opinion.

foreign oil and gas extraction income (FOGEI) was computed by determining plaintiff's life insurance company taxable income (LICTI) with and without all items of income and expense attributable to the Indonesian operations. However, Travelers now argues for an entirely different computation from either the within and without method or the calculation used in 1975 through 1978. Plaintiff contends that life insurance companies are required to compute FOGEI in the same manner as other taxpayers in accordance with the rules set forth in IRC Section 907. Thus, plaintiff asserts, its FOGEI is properly computed in exactly the same manner as R&B's: as an amount equal to the partner's distributive share of the joint venture's gross income less the distributive share of the joint venture's expenses.[8] Defendant asserts that this proposed method is incorrect.

Defendant notes that Travelers is properly taxed according to the rules governing life insurance companies. The government asserts that Travelers must exclude a policyholders' share from the investment yield from the Indonesian oil joint venture in computing its Foreign Oil Related Income (FORI).[9] In addition, the government admits

---

[8] Subsequent to filing its income tax returns, Travelers filed refund claims arguing for this computation of its FOGEI for 1975 through 1980. Thus, the government has no variance objection to raise here.

[9] When discussing the foreign tax credit limitation, Travelers speaks in terms of "FOGEI" and defendant in terms of "FORI". The parties agree that numerically FOGEI and FORI are the same. Section 907(c) defines FOGEI and FORI the same except that FORI includes certain oil-related business activities which are not relevant here. Travelers uses the term "FOGEI" because it is arguing that section 907(a) is the effective limitation while 907(b) "has virtually no impact . . . because section 907(a) already has operated to limit the creditable taxes to an amount equal to the U.S. taxes paid on FOGEI." Plaintiff's Brief in Support of

that its computation of Travelers' FORI for 1975 and 1978 was incorrect but contends that this error was in plaintiff's favor. Accordingly, defendant claims that it is entitled to an offset for those taxable years. Travelers argues that the Code's foreign tax credit provisions provide no basis for computing FOGEI with a policyholder's share exclusion and that this computation would result in creditable foreign taxes in an amount substantially less than Congress intended. The admission of both sides that their initial determinations were incorrect provides a striking illustration of the incredible complexity of this area of the tax code. It certainly appears to argue that we have created a system that may even be too complex for the highly sophisticated tax lawyers and accountants who must work with it.

DISCUSSION

I. STATUTORY FRAMEWORK

The initial question in this case is whether plaintiff should be taxed on its Indonesian oil income as a partner in the joint venture, or as a life insurance company investor. To arrive at the answer to this question, it is necessary to examine the statutory scheme for foreign investment and life insurance income taxation. That is, the court must determine whether Sections 901, 904 and 907 (which provide for the

---

Plaintiff's Opposition to Cross-Motion of the United States at 3. Defendant similarly argues that "[s]ection 907(a), limiting the amount of creditable foreign taxes, does not affect the result here. Of greater significance ... [is] section 907(b) [which] requires a separate foreign tax credit limitation computation for taxes imposed upon FORI." Reply Brief for the United States at 8. Thus, the parties simply use the terminology of the subsection they view as controlling.

foreign tax credit) are modified by Sections 802, 804, 809 and 841 (the relevant life insurance company taxation provisions).

A. The Foreign Tax Credit Limitation

The foreign tax credit rules are designed to prevent double taxation of United States taxpayers' foreign operations while preventing those taxpayers from using their foreign operations to reduce the tax on their domestic operations. Section 901 provides for a foreign tax credit subject to the limitations of Section 904. Section 904(a) provides that "[t]he total amount of the credit taken under Section 901(a) shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States . . . bears to his entire taxable income for the same taxable year." 26 U.S.C. 904(a) (1954). This limitation can be expressed by the following equation:

$$\text{total pre-credit U.S. taxes} \times \frac{\text{foreign source taxable income}}{\text{total worldwide taxable income}} = \text{limitation}$$

Motors Insurance Corp. v. United States, 208 Ct. Cl. 571, 575 (1976). The critical factor in determining the amount of the foreign tax credit limitation is the fraction representing foreign source taxable income (the numerator) over the worldwide taxable income (the denominator). Obviously, the larger the fraction, the larger the potential credit.

In 1975, Congress enacted Section 907, which provides special rules for the allowable tax credit for foreign oil income. For purposes of the foreign tax credit, Section 907(a) reduces the amount of any foreign oil and gas

extraction taxes to FOGEI multiplied by the Section 11 corporate tax rate.[10] Section 907(b) applies the same limitation fraction as provided in Section 904, but substitutes foreign oil related income (FORI) in the numerator. Thus, the difference between Sections 907(a) and 907(b) can be expressed algebraically as follows:

Section 907(a):

FOGEI x corporate tax rate = limitation

[10] For example, assume that a corporation's FOGEI was $100 and the corporation had paid $40 in foreign taxes. If the corporation was subject to a 30% domestic tax rate, only $30 would be creditable under 907(a), as foreign taxes are reduced by the amount by which such taxes exceed the corporation's FOGEI times the corporate rate.

Section 907(b):

$$\text{total pre-credit U.S. taxes} \times \frac{\text{FORI}}{\text{total worldwide taxable income}} = \text{limitation}^{11}$$

Under Section 907(c)(3)(D), FOGEI and FORI are defined as including the foreign source income of domestic corporations as well as "the taxpayer's distributive share of the income of partnerships." Plaintiff argues that the foreign credit limitation analysis stops here as Section 907 expressly

---

[11] Defendant provides the following example to illustrate the application of the foreign tax credit limitation:

> Assume that Corporation X earns $100 from United States operations and $100 from British operations in one year. Assume further that the applicable United States tax rate is 30 percent, while the British tax rate is 50 percent, and that the British tax of $50 is creditable under Section 901(b). As Corp. X has foreign source taxable income of $100 and world-wide taxable income of $200, and the United States pre-credit tax is $60 ($200 × 30%), the foreign tax credit limitation is expressed algebraically as follows:
>
> $\frac{\$100}{\$200} \times \$60 =$ Foreign tax credit limitation
>
> Thus, Corp. X receives a foreign tax credit of $30, the equivalent of the United States tax rate applied against the foreign source taxable income. The combined tax burden upon Corp. X's British operations has been reduced from $80 ($30 United States tax and $50 British tax) to $50. . . . Corp. X thus earns the same $50 in after tax income from its British operations as a British company engaged in the same business.

Cross-Motion of the United States for Partial Summary Judgment at 16 n. 9.

recognizes partnership income in computing FOGEI and FORI, but is silent as to life insurance company income.

B. Life Insurance Company Taxation Rules

The government contends that the foreign tax credit limitation fraction is further modified where the taxpayer is a life insurance company. Under Section 841:

> [t]he taxes imposed by foreign countries . . . shall be allowed as a credit against the tax of a domestic insurance company subject to the tax imposed by section 802, 821, or 831, to the extent provided in the case of a domestic corporation in section 901 (relating to foreign tax credit). For purposes of the preceding sentence . . . the term "taxable income" as used in section 904 means —
>
> (1) in the case of the tax imposed by section 802, the life insurance company taxable income (as deemed in section 802(b)).

26 U.S.C. 841. Defendant asserts that the Code thus establishes that "taxable income," as used in both the numerator and the denominator of the foreign tax credit limitation fraction, is determined by reference to life insurance company taxable income (LICTI). LICTI is defined under Section 802(b) as the sum of:

> (1) the taxable investment income (as defined in section 804) or if smaller, the gain from operations (as defined in section 809)

> (2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus
> (3) the amount subtracted from the policyholders' surplus account for the taxable year, as determined under section 815.

26 U.S.C. 802(b).[12]

Sections 804 (a)(1) and 8O9(a)(1), in turn, define taxable investment income and gain from operations as excluding the "policyholders' share of each and every item of investment yield." Defendant argues that this language clearly requires exclusion of the policyholders' share of investment yield in computing Travelers FORI. Thus, in the government's view, the foreign tax credit fraction is further altered:

$$\text{total pre-credit U.S. taxes} \times \frac{\text{foreign source LICTI attributable to FORI}}{\text{worldwide LICTI}} = \text{limitation}$$

Thus, the court must engage in a two-tiered inquiry in analyzing this case. First, the court must resolve the parties arguments under 907(a), (b), and (c). To do so, the court must determine: (A) which subsection of 907 is the critical limitation on the foreign tax credit, and (B) whether 907(c) operates to allow plaintiff to treat its FOGEI/FORI as the distributive share of a partnership with R&B. Assuming that the court concludes that the government has properly applied

---

[12] The three elements of LICTI are also called "phases." Travelers did not have any Phase III, or subtraction from policyholders' surplus account, income for the years in question.

907 (a) and (b), and that plaintiff cannot compute its FOGEI/FORI in the same manner as its partner, the court must then turn to the second tier of inquiry: whether the life insurance taxation rules modify the foreign tax credit limitation. To resolve that issue, the court must also determine two questions: (A) whether the government has applied the applicable sourcing rules in excluding the policyholders' share from Travelers' FOGEI/FORI, and (B) if it has not, whether plaintiff's computation would constitute an impermissible change in accounting method.

II. THE PARTIES' SECTION 907 DISPUTE

A. Sections 907(a) and (b) and the Foreign Tax Credit Limitation

Plaintiff asserts that defendant's computation of the foreign tax credit limitation ignores Section 907(a). In Travelers' view of Section 907(a), its creditable taxes are reduced to an amount equal to the product of FOGEI multiplied by the Section 11 corporate tax rate. Section 907(b) then applies a special foreign tax credit limitation to the reduced amount of creditable taxes by requiring that FORI be the numerator in the limitation fraction. In support of this contention, Travelers cites the Treasury Department's preamble to the regulations promulgated under Section 907:

> Section 907(a) reduces otherwise creditable foreign income taxes imposed on "foreign oil and gas extraction income" to a certain percentage of this income.
>
> * * *

> Section 907(b) creates a separate section 904 limitation for "foreign oil related income". Section 907(c)(2) defines foreign oil related income to include income from "downstream" trade or business, such as the processing of minerals from oil or gas wells into primary products. . . .
>
> Section 907(a) applies before section 907(b). To summarize, section 907(a) initially reduces creditable foreign oil and gas extraction taxes to a certain percentage of the foreign oil and gas extraction income. Section 907(b), on the other hand, in essence then provides that the extraction taxes as reduced by section 907(a) along with the creditable taxes on the income from downstream trades or businesses can only be used under Section 904 to reduce the U.S. tax on foreign oil related income. Section 907(a) does not reduce the creditable foreign taxes imposed on the income from downstream trades or businesses.

T.D. 7961, 1984-2 C.B. 130, 132.

Defendant contends that it is irrelevant in this case whether Section 907(a) is applied before 907(b). The government argues that Section 901(a) limits the allowable foreign tax credit to the lesser of (1) the limitation upon creditable taxes, computed pursuant to Section 907(a), and (2) the special foreign tax credit limitation, computed pursuant to Section 907(b). As FOGEI and FORI are computed independently, the government asserts that basic algebra proves that it makes no difference which limitation is computed first.

While the Treasury Department's preamble is instructive, the court fails to see why applying Section 907(a) first in this ease would be of any consequence. The preamble provides that the only change between the computations under Sections 907(a) and (b) is that the former "does not reduce the creditable taxes imposed on the income from downstream trades or business." As the parties agree that downstream trade income is not at issue in this case, and that plaintiff's FOGEI and FORI are identical, the order of application of the subsections is not critical. Under defendant's computation, Section 907(b) imposes the greatest restriction upon Travelers' allowable foreign tax credit related to the Indonesian oil venture. Thus, Section 907(b) provides the lesser foreign tax credit under Section 901(a), and is the operative limitation in this case.[13] However, even assuming that Section 907(a) must be applied first, plaintiff cannot show that it is entitled to treat its FORI as equal to the distributive share of income and expenses from the Indonesian oil venture without reference to the life insurance company taxation rules.

B. Whether Section 907(c) requires that Travelers be treated as a partnership.

Plaintiff argues that because Section 907(c)(3)(D) expressly provides that FORI includes the taxpayer's distributive share of the income of a partnership engaged in a foreign oil business, Travelers should be taxed in the same manner as R&B. Defendant responds that Section 907(c) is inapplicable here as Travelers elected under Section 761(a) not to be treated as a partner under Subchapter K of the Code.

---

[13] For that reason, the court uses the term "FORI" in the remainder of this opinion.

The court finds that both the Section 761 election and the language of Section 907(c) preclude the treatment of plaintiff's income as the distributive share of a partnership in this case.

Travelers does not dispute that it expressly elected to exclude the Indonesian oil venture from the partnership taxation rules codified in Subchapter K (Sections 701-761). Rather, plaintiff contends that its election is irrelevant because it was limited to Subchapter K. However, "distributive share of partnership income" under Section 907(c)(3)(D) is defined only in Section 704. Section 704, of course, is one of the provisions indisputably effected by Travelers' election. Plaintiff cites *Bryant v. Commissioner*, 46 T.C. 848, 864 (1966), *aff'd* 399 F.2d 800 (5th Cir. 1968), for the proposition that a Section 761 election is ineffective for purposes unrelated to Subchapter K. In that case, however, the court found that Section 761 and the investment tax credit provision at issue were not "interdependent." *Id.* In this case, Section 907(c) and Subchapter K are plainly interdependent as the latter defines the terms of the former. The court notes that Travelers admitted in its opening brief that "the principles of Section 704 govern in determining FOGEI."[14] Thus, Travelers' election under Section 761 operated to render Section 907(c)(3)(D) inapplicable to its FORI computation.

Even if Travelers' election did not render Section 907(c)(3)(D) inapplicable, plaintiff misconstrues the provision. Section 907(c)(3)(D) does not require, as plaintiff suggests, that Travelers be taxed as a partner in the

---

[14] Plaintiff's Brief in Support of Motion of Plaintiff for Partial Summary Judgment at 14.

Indonesian oil venture. As set forth above, Section 907(c)(3) provides:

> The term "foreign oil and gas extraction income" and the term "foreign oil related income" *include* —
>
> * * *
>
> (D) the taxpayer's distributive share of the income of partnerships. . . .

(Emphasis Added). While partnership income is included in the definition of FOGEI and FORI, the "distributive share of income from partnerships" is not the exclusive definition. The legislative history of Section 907 indicates that Congress intended a very broad definition of FOGEI and FORI to ensure that United States oil companies could not avoid application of the Section 907 rules by creatively structuring their foreign oil operations.[15] Thus, FORI includes income

---

[15] As set forth in the Committee Report on the Energy Tax and Individual Relief Act of 1974:

> There are various forms of arrangements used today whereby U.S. petroleum companies which operate overseas extract their own production of oil and gas and also purchase from the foreign government the foreign government's share of the oil and gas production. In addition, there are arrangements whereby the petroleum company which conducts oil and gas extraction operations sells a percentage or a portion of its production to a second petroleum company who pays taxes on the operations to the foreign government. Due to the changing relationships between the foreign governments of the countries where oil and gas wells are located and the petroleum companies operating in those countries, it is quite possible that other types of

from a variety of business arrangements. Travelers cites no authority for the proposition that Section 907(c) is limited to any particular oil extraction business arrangement or that the statute excludes the computation of foreign source taxable income for life insurance companies.

In support of its contention that Section 907(c)'s partnership language provides the exclusive method of computing its foreign tax credit limitation, plaintiff cites *Federated Mutual Implement and Hardware Insurance Co. v. Commissioner*, 266 F.2d 66 (8th Cir. 1959) and *Northwestern Mutual Fire Ass'n v. Commissioner*, 181 F.2d 133 (9th Cir. 1959). However, plaintiff's reliance on these cases is misplaced. Both cases stand for the proposition that when the statute provides the exclusive method for computing the foreign tax credit limitation, that method applies even in the case of a mutual insurance company. In *Federated Mutual* and *Northwestern Mutual*, the operative mutual insurance company tax provisions required computation of taxable income as the greater of "normal-tax net income" or "gross amount of income." Normal tax-net income was defined as that derived from net investment income; gross income included interest, dividends and premiums less dividends to policyholders. The numerator of the foreign tax credit

---

> arrangements similar to the ones described above will arise under which a petroleum company no longer extracts crude oil products but purchases and sells crude oil . . . on behalf of the foreign government. To the extent that profits on these types of arrangements are profits from the extraction or crude oil [this bill] treats them as income. . . .

H. Rpt. No. 93-1502, 93d Cong. 2d Sess. at 64-65 (1974). Thus, Congress intended that, however structured, oil extraction businesses would be subject to the Section 907 rules for the income derived in foreign operations

limitation fraction was statutorily defined as "normal-tax net income" earned in the foreign country, while the denominator was defined as the taxpayer's entire normal-tax net income.[16] Internal Revenue Code of 1939, Section 131. Thus, the 1939 Code provided two special bases for mutual insurance companies, neither of which was the generally applicable tax base of normal-tax net income as defined for the foreign tax credit limitation.

In *Northwestern Mutual*, the taxpayer originally computed its limitation by adopting the ratio of gross amount of income from Canadian sources to gross amount of income from all sources. Northwestern later filed for a refund claiming that the proper ratio in the limitation was normal-tax net income from Canada to normal-tax net income from all sources. The court allowed the refund because the statute's clear and unambiguous language required such a computation. In so holding, the court acknowledged that the United States taxes imposed upon Northwestern Mutual during the years in question were not based upon its normal-tax net income but rather upon its gross income.

> In view of that fact, limitation of the foreign tax credit by a ratio of normal-tax net income appears to have no logical basis. But as legislative history reveals, mutual insurance companies such as petitioner present unusual problems of administration. Resolution of these problems has been made, if empirically,

---

[16] Therefore, under the 1939 Code, "normal- tax net income" for mutual insurance companies was defined differently than the normal-tax net income in the foreign tax credit limitation. See E. OWENS, THE FOREIGN TAX CREDIT, at 210-211 (1961).

> by the Congress. Our function is at an end when we have determined the scope of the Congressional action.

Id. at 136. The court in *Federated Mutual* reached the same conclusion, holding that the statutory language requiring use of "normal-tax net income" in computing the limitation applied regardless of whether the company's taxable income was computed using gross amount of income as an alternative tax base.[17]

Thus, these cases stand for the wholly unremarkable proposition that courts are bound by relevant statutory provisions. This explains why both parties in this case find *Federated Mutual* and *Northwestern Mutual* supportive of their respective positions. However, what is at issue in this case is which statutory provision controls, or whether both Sections 907 and 841 can be read compatibly. "The courts are not at liberty to pick and choose among congressional enactments, and where two statutes are capable of co-existence, it is the duty of the courts, absent a clearly expressed congressional intention to the contrary, to regard each as effective." *Morton v. Mancari*, 417 U.S. 535, 551 (1974); see also *Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1018 (1984) (The better interpretation of arguably conflicting statutes capable of co-existing is one which gives force to both). As plaintiff can cite to no "clearly expressed

---

[17] However, unlike the predecessor provision considered in *Federated Mutual*, section 907(c) does not expressly provide the exclusive method of determining the numerator in the foreign tax credit limitation fraction. As explained above, Section 904(a) provides that the numerator shall be the "foreign source taxable income." While that can be determined by reference to partnership income under 907(c), it can also be computed by reference to the Section 841 LICTI.

congressional intent," this court must, if possible, adopt a construction which allows Sections 907 and 841 to co-exist. Plaintiff's claimed entitlement to treatment as a partnership for this purpose must thus be rejected.

III. THE ALLOCATION OF EXCLUSIONS AND DEDUCTIONS FROM PLAINTIFF'S FORI

As explained above, Section 841 provides that where the taxpayer is a life insurance company, foreign source taxable income (FORI in this case) is statutorily defined in terms of LICTI. Section 802(a) provides that the two principal components of LICTI are taxable investment income and gain from operations. Both components are defined as excluding the "policyholders" share of each and every item of investment yield." Sections 804(a)(1) and 809(a)(1). Thus, defendant argues that Travelers' FORI is computed by excluding the policyholders' share from plaintiffs' Indonesian oil investment yield. In addition, the government contends that the principle of using the same methodology in computing the numerator and denominator of the foreign tax credit limitation fraction requires the exclusion of a policyholders' share from Travelers' Indonesian oil investment yield.

Plaintiff argues that even if the above life insurance company taxation rules apply in computing its foreign tax credit limitation, these rules lead to the result urged by Travelers. Travelers contends that defendant's calculation of FORI does not follow the methodology required under general income sourcing rules. Plaintiff asserts that under the general source rules, no part of its excess gain from operations is allocable to the Indonesian oil gross income. In addition, Travelers argues that the policyholders' share exclusion is, in fact, a deduction which must be allocated only

to its domestic insurance activities. These arguments, and defendant's responses to them, are addressed below.

A. The General Income Sourcing Rules: Sections 861-864

1. Travelers' Excess Gain From Operations in the FORI Computation

In 1976-1977 and 1979-1980, plaintiff asserts that its United States tax base was "phase 2 positive." That means that plaintiff was entitled under Section 802(b) to defer recognition of one-half of its gain from operations (GFO) over its taxable investment income. Plaintiff contends that its phase- two GFO is a special deduction allocated to gross income under the income sourcing regulations underlying Sections 861-864. Under Treas. Reg. § 1.861-8(b)(2), "[a] deduction shall be considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived." Travelers argues that, under this regulation, its excess GFO is attributable to gross income derived from insurance activities, not to plaintiff's Indonesian oil income. Plaintiff asserts that defendant has ignored these sourcing rules in computing its FORI by creating a Section 802(b) deduction sourced to the Indonesian oil income.

Defendant responds that it has not "created" an excess GFO deduction in computing Travelers' FORI. The government contends that it simply followed the Section 802(b)(2) requirement of deferring income recognition of 50 percent of the amount by which gain from operations exceeds the taxable investment income. Thus, defendant argues that the excess GFO is a deferral or exclusion from income and

the Treas. Reg 1.861-8 rule for sourcing deductions is inapplicable. The dispute over what may be properly termed a deduction or exclusion is central to the policyholders' share issue in this case. Therefore, the court will consider the parties' excess GFO arguments in that context below.

2. The Policyholders' Share Exclusion in the FORI Computation

Life insurance companies are taxed differently from other taxpayers because most of their current revenue is obligated to pay future claims. The three-phase system of life insurance taxation was designed "in recognition of the traditional concept that a life insurance company should not be taxed on that part of its income which was required to be set aside as a reserve to meet the company's contingent obligations to its policyholders." MERTENS LAW OF FEDERAL INCOME TAXATION §44a.02 at 16. To implement this concept, a life insurance company is entitled to a deduction for increases to its reserves as premiums and investment income are received. A policyholders' share is excluded from "each and every item of investment yield" to ensure that only the company's share is subject to tax. D. VAN MIEGHAM and T. BROWN, FEDERAL TAXATION OF INSURANCE COMPANIES, Section 1.25 (1987).

Plaintiff contends that the policyholders' share exclusion is part of the reserve deduction and is, therefore, allocable to its U.S. insurance related- income under Treas. Reg 1.861-8. Travelers points out that the parties agree that no part of plaintiff's deductions for its insurance-related income (such as reserve increases or benefits paid to policyholders) is sourced to Indonesia. Thus, plaintiff asserts, the policyholders' share cannot be so allocated as it is directly related to the increases in reserves. Travelers views the

policyholders' share as the required interest portion of plaintiff's insurance reserves, which represent an anticipation of claims for policy benefits. As such, Travelers asserts that the policyholders' share must be treated consistently with the deduction for reserve increases and policy benefits and be sourced to domestic insurance related activities.

Defendant contends that Treas. Reg. § 1.861-7(a) treats income from the sale of personal property as derived from the country where the property is sold. Thus, the government asserts that Travelers' income from the sale of oil is sourced to Indonesia. Defendant then argues that Sections 804(a) and 809(a) require exclusion of the policyholders' share of each and every item of investment yield and, therefore, reduce the amount of Indonesian source oil income recognized. Defendant argues that Treas. Reg. § 1.861-8 applies only to the sourcing of expenses, losses and other deductions from the Indonesian oil venture. In the government's view, Treas. Reg. § 1.861-8 is otherwise inapplicable because the policyholders' share is an exclusion and not a deduction. Thus, in order to decide how the policyholders' share is to be sourced, the court must determine whether the policyholders' share is a reduction in the deduction created by an increase in plaintiff's insurance reserves.

Both parties present coherent arguments for their positions on the nature of the policyholders' share. Defendant relies upon the express characterization of the policyholders' share as an "exclusion" under Sections 804(a)(1) and 809(a)(1). The government points out that the tax law distinguishes between exclusions and deductions. For example, the insurance provisions distinguish between the policyholders' share exclusion from gain from operations (809(a)(1)) and deductions from the same (809(d)). In

addition, the legislative history indicates that Congress specifically designated the policyholders' share as an exclusion after initially labeling it as a deduction.[18] Thus, the government would have the court treat as an exclusion anything so labelled.

Although appealing, as bright line tests always are, the court cannot accept defendant's contentions. As the court stated in *Life Insurance Company of Georgia v. United States*, 16 Cl. Ct. 359 (1989), "it is incorrect to view an expense as 'the immediate occasion, or the result of, the receipt of income." *Id.* at 362. Instead, such costs are the result of activities that produce income. "The guiding discipline, in other words, is one in which the 'why' of the expense is the essential determinant of its allocation." *Id.* In this case, as plaintiff aptly points out, the "why" of the policyholders' share is a dollar-for-dollar reduction in the deduction for increases in reserves.[19]

---

[18] The House version of the Life Insurance Company Income Tax Act of 1959 treated policyholder requirements as a deduction. The Senate version characterizing the policyholders' share as an exclusion was ultimately embodied in the statute. S. Rept. No. 291, 86th Cong., 1st Sess. (1959).

[19] Defendant argues that even if the policyholders' share is a deduction, the source of those deductions is the situs of the investment. In support of this contention, the government relies primarily upon *Commissioner v. Ferro-Enamel Corp.*, 134 F.2d 564 (6th Cir. 1943) and *Royal Insurance Co. v. Commissioner*, 38 B.T.A. 955 (1938). However, those cases involve the sourcing of capital losses on the disposition of capital assets and not the allocation of deductions to sources of income. Those losses would not have been incurred but for the investment. In the instant case, the policyholders' share would have been required whether or not plaintiff had invested in the Indonesian oil venture.

The policyholders' share percentage is determined by dividing the required interest portion of the reserves by the investment yield. Under 809(a)(2), required interest is defined as the sum of the products obtained by multiplying:

> (A) each rate of interest required, or assumed by the taxpayer, in calculating the reserves described in section 810(c), by
>
> (B) the [mathematical] means of the amount of such reserves computed at that rate at the beginning and end of the taxable year.[20]

Under Section 810, the amount of net increase or decrease in reserves "must first be reduced by the amount of investment yield not included in the gain or loss from operations for the taxable year by reason of Section 809(a)(1)." Treas. Reg. § 1.810-2(c)(1). Thus, gain from operations is reduced by the policyholders' share of investment yield under Section 809(a)

---

[20] In 1975 for example, Travelers' Section 809 policyholders' share was determined by the following calculation:

	1. Rate	2. Beginning of Year	3. End of Year	4. Mean of Col. 2 & 3	5. Col. 1 x 4
1. 810(c)(1) reserve					133,810,334
2. 810(c)(3)	3.2880	145,542,343	147,459,588	146,500,968	4,816,880
3. 810(c)(4)	7.9986	320,774,041	644,599,048	482,686,565	38,608,146
4. 810(c)(5)	7.7309	115,674,801	140,051,208	127,863,005	9,884,911
5. 810(c)(6)	6.4524	87,872,679	95,543,747	91,708,213	5,917,410
Required Interest (lines 1 through 5)					193,037,681

Defendant's Exhibit B 212.

and then increased by the same amount by the adjustment to year-end reserves in Section 810.

However, only the year-end reserves are reduced by the policyholders' share of investment yield deduction. Unlike the year-end reserves, the opening reserves for the following year are not reduced by the policyholders' share. Therefore, the life insurance company must each year recognize the full amount of investment yield, obtain a full deduction for reserve increases, and prorate tax exempt interest and dividends received to the reserves. Thus, plaintiff is correct that the exclusion of the policyholders' share of investment yield is not an exclusion from gross income. Because the policyholders' share applies to a net figure, it is accurately viewed as a deduction. In reality, the policyholders' share exclusion is the required interest portion of the reserve deduction which is fully recouped by the corresponding decrease in the year-end reserves under Section 810.[21]

---

[21] A similar scheme was encountered in *Allstate Insurance Company v. United States*, 936 F.2d 1271 (Fed. Cir. 1991). In that case, upon submission of a claim from automobile insurance policyholders, the plaintiff would evaluate the claim and make an addition to its unpaid loss reserves. Allstate later paid many of those claims in sums different from the original claimed amount. Upon payment, Allstate subtracted the original amount it had estimated from the unpaid loss reserves and added the amount actually paid to its paid losses account. Thus, the unpaid loss reserves reflected Allstate's potential future obligations. After it paid the claim, Allstate could seek recovery from a third party (subrogation) or sell the damaged automobile for scrap (salvage). Greater subrogation amounts reduced the losses incurred deduction and increased Allstate's gross income. Plaintiff argued that it was unnecessary to include as income that portion of the subrogation and salvage received which related to earlier losses deducted without tax benefit.

The Federal Circuit noted that the tax benefit rule allows a

In determining the allocation of an item of income, the court must look to its substance. *Bank of America v. United States*, 230 Ct. Cl. 679 (1981). As the court has determined that the policyholders' share is directly related to the deduction for reserves, the deduction sourcing rule of Treas. Reg. § 1.861-8 applies.[22] Thus, the policyholders' share is properly allocated to Travelers' gross income from its domestic insurance business and not to its Indonesian oil investment activities.[23]

---

taxpayer to exclude from income amounts recovered from a previously deducted loss to the extent the previous deduction generated no tax benefit. Thus, the tax benefit rule applied to exclude salvage and subrogation recoveries from Allstate's income despite the government's argument that the statute provided that such recoveries were an offset to the deduction for losses incurred and not an item of gross income. In so holding, the court of appeals found that the tax structure resulted in a "dollar-for-dollar" increase in the taxpayer's gross income. *Id.* at 1274. In the instant case, plaintiff's gross income includes the policyholders' share as it reduces the deduction for increases in reserves dollar-for-dollar.

[22] Because the excess GFO deduction discussed above is attributable to gross income derived from insurance activities, it is similarly sourced under Treas. Reg. § 1.861-8(b)(2).

[23] This conclusion is supported by the analogous Section 953 regulations governing income of controlled foreign corporations. Under Section 953, certain shareholders of foreign controlled corporations are required to include in income the amounts of their "Subpart F" income. Subpart F income includes insurance income "derived from the insurance of United States risks." Treas. Reg. § 1.953-4(h) Example (d) determines the life insurance company share of investment yield attributable to foreign risks by subtracting the required interest attributable to the reserves on foreign risks from the total investment income allocable to those risks. Thus, the policyholders' share of investment risks is equated with required interest and is an expense allocable to the source of the insurance risks to which it relates and not to all items of investment yield.

B. Change in Accounting Method

Defendant argues that even if the policyholders' share is a deduction to which Treas. Reg. § 1.861-8 applies, plaintiff's proposed FORI computation would constitute an impermissible change in accounting method under Section 446(e). Section 446(e) provides:

> a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary.

Defendant argues that because Travelers computed its foreign tax credit limitation using the same method as the Service on its returns for 1975 through 1978, Travelers' argument for a different computation violates Section 446(e). Because Travelers never filed a Form 3115 (Request for Consent to Change Method of Accounting), defendant asserts that plaintiff may not now change its computation of FORI.

However, Treas. Reg. § 1.446-1(e)(2)(ii)(b) provides that a change in method of accounting does not encompass "errors in the computation of the foreign tax credit." A change of accounting is one which changes the treatment of a "material item." *Schuster's Express, Inc. v. Commissioner*, 66 T.C. 588, 595 (1976), *aff'd mem.*, 562 F.2d 39 (2d Cir. 1977). A material item is any item which involves the proper time for the inclusion of an item in income or the taking of a deduction. Treas. Reg. § 1.446-1(e)(2)(ii)(a). The foreign tax credit computation takes place only after taxable income has

been determined and all timing matters have been resolved.[24] Therefore, plaintiff's proposed computation does not constitute a change in accounting method under Section 446(e).

C. The Government's Offset Claim

Defendant admits that the IRS' calculation of Travelers' FORI for 1975 and 1978 was incorrect in one "minor" respect. As explained above, Section 841 defines "taxable income" for purposes of the foreign tax credit limitation in terms of LICTI which is defined as taxable investment income and gain from operations. Foreign tax credit principles require that both the numerator and denominator of the foreign tax credit limitation be computed on the same basis. However, the IRS' computation in 1975 and 1978 reported Travelers' FORI (the numerator) on the basis of combined taxable investment income and gain from operations, while plaintiff's worldwide taxable income (the denominator) was based upon only taxable investment income. In other words, defendant contends that the IRS excluded the wrong policyholders' share from plaintiff's FORI for those years. The government contends that this error was

---

[24] Travelers also asserts that its computation is permissible because it is merely the correction of an error and it may change its accounting method by filing amended returns. The government disputes this contention and relies upon *Diebold v. United States*, 891 F.2d 1579 (Fed. Cir. 1989), *cert. denied*, 111 S. Ct. 73 (1990). In *Diebold*, the court held that a taxpayer was still required to obtain consent even though it sought to amend its tax returns. *Id.* at 1583. However, the primary focus of *Diebold* was not on the amendment issue, but on whether there was a change in accounting method. Thus, *Diebold* is inapplicable here because there was no change of accounting method in this case.

to Travelers' advantage and, therefore, defendant is entitled to an offset for the amount of the mistake.

As discussed above, although the life insurance tax rules apply to the foreign tax credit limitation, plaintiff has shown that defendant's exclusion of the policyholders' share from Travelers' FORI was improper. As defendant's offset claim is also based upon its assertion that a policyholders' share must be excluded from Travelers' FORI, it is unnecessary to consider the government's argument that it is entitled to an offset because the IRS excluded the wrong policyholders' share in its audit computation for 1975 and 1978. Thus, the offset claim must be denied.

CONCLUSION

For the reasons set forth above, the policyholders' share was improperly excluded from plaintiff's Indonesian oil investment yield. Accordingly, plaintiff's motion for partial summary judgment is granted. The parties are directed to submit a joint status report within sixty days advising the court of the effect of this decision upon future proceedings in this case.

IT IS SO ORDERED.

/s/
LOREN A. SMITH
Chief Judge

United States Court of Appeals for the Federal Circuit

01-5137

THE TRAVELERS INSURANCE COMPANY,

Plaintiff-Appellee,

v.

UNITED STATES,

Defendant-Appellant.

Peter H. Winslow, Scribner, Hall & Thompson, LLP, of Washington, DC, filed a petition for panel rehearing for plaintiff-appellee.

Edward T. Perelmuter, Attorney, Tax Division, Department of Justice, of Washington, DC, filed a response to the petition for defendant-appellant. With him on the response were Eileen J. O'Connor, Assistant Attorney General; David English Carmack, and David I. Pincus, Attorneys.

Appealed from: United States Court of Federal Claims

Senior Judge Loren A. Smith

United States Court of Appeals for the Federal Circuit

01-5137

THE TRAVELERS INSURANCE COMPANY,

Plaintiff-Appellee,

v.

UNITED STATES,

Defendant-Appellant.

ON PETITION FOR PANEL REHEARING

ORDER

Before SCHALL, DYK, and PROST, Circuit Judges.

Travelers has petitioned for panel rehearing of the court's September 16, 2002, decision. Travelers Ins. Co. v. United States, 303 F.3d 1373 (Fed. Cir. 2002).

Travelers argues that we should remand this case because, even under our original decision, issues remain to be resolved by the Court of Federal Claims concerning the foreign tax credit issue. The court invited the United States to respond. In its response, the government initially urged that no issues remained to be resolved. (Appellant's Resp. to Pet. for Panel Reh'g.) However, by letter dated January 21,

2003, the government advised us that, on further reflection, it agreed that one issue remains to be resolved, namely whether "the IRS made a computational error with respect to the 1975 and 1978 taxable years." Under these circumstances we agree that a remand is appropriate for this limited purpose. However, we reject the taxpayer's contention that a remand is required to address other issues concerning the foreign tax credit.[1]

The taxpayer also seeks reconsideration of our decision with respect to the foreign currency translation issue. Taxpayer has not offered sufficient reason to reconsider that decision, and we decline to do so.

IT IS ORDERED THAT:

(1) The Petition for Rehearing is granted-in-part and denied-in-part.

(2) The case is remanded to the Court of Federal Claims for the limited purpose of determining whether the IRS made a computational error with respect to the 1975 and 1978 taxable years.

---

1 Travelers argues that 1) it is "entitled to deduct or exclude from its tax base under [26 U.S.C. §] 802(b) 50% of its [positive] underwriting income" for the periods from 1976-77 and 1979-80, and 2) treatment of the policyholders' share as an exclusion "increas[es] Travelers' foreign tax credit limitation." (Appellee's Pet. for Panel Reh'g at 5-6.)

FOR THE COURT

February 24, 2003
Date

/s/
Jan Horbaly
Clerk

FILED
U.S. COURT OF APPEALS FOR
THE FEDERAL CIRCUIT

FEB 24 2003

JAN HORBALY
CLERK

United States Court of Appeals for the Federal Court

01-5137

THE TRAVELERS INSURANCE COMPANY,
Plaintiff-Appellee,

v.

UNITED STATES,
Defendant-Appellant.

Judgment

ON APPEAL from the United States Court of Federal Claims

in CASE NO(S). 88-CV-494 and 89-CV-262

This CAUSE having been heard and considered, it is

ORDERED and ADJUDGED:

reverse

ENTERED BY ORDER OF THE COURT

DATED Sept. 16, 2002 /s/
Jan Horbaly, Clerk

ISSUED AS A MANDATE: Apr. 17, 2003